APPENDIX A

UNITED STATES COURT OF APPEALS
FIRST CIRCUIT

No. 96-1877

UNUM CORPORATION and UNUM LIFE INSURANCE COMPANY OF AMERICA,
Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

Heard Sept. 9, 1997
Decided Dec. 2, 1997

Before TORRUELLA, Chief Judge, ALDRICH, Senior Circuit Judge, and LYNCH, Circuit Judge.

LYNCH, Circuit Judge.

The need to raise capital and to compete in increasingly diversified financial markets has led a number of American mutual life insurance companies to convert to being stock companies. This process, known as "demutualization," often involves a conversion of the mutual policyholders' ownership interest in the old company into ownership interest in the form of stock in the new company.

This appeal raises important questions about the proper tax treatment of one form of demutualization: whether

stock and cash distributed to policyholders in exchange for their mutual ownership interests as part of a statutory demutualization constitute "policyholder dividends" under § 808 of the Internal Revenue Code. If so, the insurer may take a deduction for "policyholder dividends" under § 805(a)(3). Whether the "policyholder dividends" deduction is available has great financial consequences for the company and for the public fisc. This question involves consideration of the scope of the "policyholder dividend" under § 808, as well as the broader relationship between the general corporate tax provisions of the Code (contained in Subchapter C) and the Code's insurance tax provisions (contained in Subchapter L).

In this case, UNUM Corp. ("UNUM"), the demutualized successor to Union Mutual Life Insurance Co. ("Union Mutual"), seeks a tax refund based on a "policyholder dividends" deduction of over $652 million. This sum, which UNUM was required to distribute to its policyholders by state law, represents the value of Union Mutual's accumulated surplus. *See* Me.Rev.Stat. Ann. tit. 24-A, § 3477 (West 1996).

UNUM's principal argument is that the cash and stock distributed during the demutualization constitute "policyholder dividends" under the plain language of § 808(b) and thus are deductible under § 805. UNUM further argues that, beyond the statute's plain language, the legislative history and public policy behind the Code's treatment of life insurance companies support this result.

The IRS argues that general corporate tax provisions apply to insurance companies in the absence of specific provisions to the contrary in the Code's insurance tax section, and that, under those corporate tax provisions, UNUM is not entitled to any deduction for its reorganization. The IRS argues that nothing in § 808 or its legislative history indicates that Congress envisioned § 808 as encompassing capital transactions such as UNUM's de-

mutualization. Rather, placed in proper context, § 808 is not relevant to the value-for-value exchanges for which UNUM seeks a deduction.

The district court entered judgment for the government in UNUM's suit for a refund. We affirm the judgment of the district court.

I

This appeal involves only questions of law; we exercise *de novo* review. *Alexander v. Internal Revenue Service,* 72 F.3d 938, 941 (1st Cir.1995). The parties have agreed on the facts.

A. *Background*

Demutualization has become increasingly common in the insurance industry. More than 200 mutual life insurance companies have demutualized since 1930. *See* S. Preston Ricardo, *The Deductibility of Policyholder Dividends: UNUM Corp. v. United States,* 50 Tax Law. 265, 265 (1996). Between 1954 and 1981, the number of mutual insurers declined from 171 to 135; during the same time, the number of stock insurers increased from 661 to 1,823. Edward X. Clinton, *The Rights of Policyholders in an Insurance Demutualization,* 41 Drake L.Rev. 657, 659 n.13 (1992). Today, fewer than 80 mutual insurers have assets of over $100 million. *See* William B. Dunham, Jr., et al., *Introduction, in Demutualization of Life Insurers,* 648 PLI/Comm 9, 16 (1993). These figures suggest that mutual insurers are rapidly demutualizing, and that new insurance companies prefer the stock form at the outset.

State legislatures have facilitated this demutualization process by passing statutes permitting such conversions. Presently, at least forty-one states have specific statutes that provide for demutualization of mutual life insurers. Alexander M. Dye, *Distributing Consideration to Policy-*

holders, in Demutualization of Life Insurers, 648 PLI/ Comm 75, 78 (1993). Only Hawaii and Idaho expressly prohibit direct mutual to stock conversion, although they still permit demutualization through the alternate method of bulk reinsurance conversion. *See* Clinton, *supra,* at 673 n.116. Every state, including those that lack specific demutualization statutes, permits at least some form of demutualization. *See id.*

There are three usual types of mutual to stock conversions: a statutory conversion whereby the insurer directly converts its form of business, merger with a stock insurer, and bulk reinsurance of the mutual company's policies. *See id.* at 660-61. This case only concerns the first type of conversion: a statutory conversion, in which a mutual company alters its organizational form to become a stock insurer by redistributing all the mutual policyholder's ownership interest in the mutual insurer into shares of stock in a new stock corporation. "This type of reorganization may properly be regarded as a reorganization of the company because the policyholders are exchanging membership in the mutual for shares in the new corporation." *Id.* at 660.

By demutualizing, mutual insurers can obtain certain advantages available to stock insurers. Stock corporations are better able to raise capital because they may sell stock on the equity markets. *See id.* at 666-671. Stock companies can more easily diversify their operations by creating upstream holding companies which can own subsidiaries engaged in other businesses. *See id.* at 671-72. They can also create incentives for superior management performance through stock option plans. *See id.* at 672-74. Mutual insurers can only raise capital by retaining earnings or charging excess premiums, and are generally subject to comprehensive regulation by state authorities. These limitations can hinder their ability to grow and diversify. *See id.* at 666.

Much is at stake in this process. Mutual insurance companies have historically lagged behind stock insurers in growth of assets and capital. Demutualization and subsequent stock sales may improve a mutual insurer's capital position and competitive standing with other insurers and financial institutions. Mutual insurers naturally want to contend in the increasingly competitive and deregulated financial services markets. Many mutual insurers regard demutualization as an important step toward bolstering their financial strength and flexibility.

B. *Facts*

Union Mutual, based in Maine, was organized as a mutual insurance company in 1848. Union Mutual's business was selling various types of insurance and annuity products. As a mutual company, Union Mutual had no stock and was owned by its participating policyholders.[1] Policyholders contributed to Union Mutual's surplus by paying premiums that exceeded the actuarial cost of their policy coverage.

In 1984, Union Mutual's management decided to reorganize the company as a stock insurer. The manage-

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[1] Mutual life insurance companies do not raise money by issuing capital stock, but rather by charging policyholders a "redundant premium" that exceeds the amount actuarially anticipated to pay the policy's benefits and expenses. The excess portions of these premiums are accumulated, retained, and invested as "surplus".

A mutual insurer's accumulated surplus is the excess of assets over liabilities. Such an excess results from the accumulation of redundant premiums and investment earnings over the life of the company. Surplus generally belongs to the mutual insurer's members in proportion to their contributions, and is generally returned to policyholders through policyholder dividends.

Mutual insurers are thus owned by their policyholders. Policyholders in mutual companies are denominated "members" of the company; their ownership rights in the company are their "membership interests". Members of mutual insurance companies have many of the same rights as stockholders in corporations, including the right to vote and the right to residual surplus upon liquidation.

ment decided that the company would gain four principal business advantages from this conversion: an increased ability to raise capital, greater flexibility to diversify into new markets, an increased accountability for company performance by management, and an enhanced ability to attract and retain key personnel.

Under Maine law, Union Mutual was not permitted to implement its conversion plan until the plan was approved by the Maine Superintendent of Insurance. *See* Me.Rev. Stat. Ann. tit. 24-A, § 3477 (West 1996). Maine law imposes several conditions that a demutualization plan must satisfy in order to receive approval by the Superintendent. These include, *inter alia,* (1) that the company pay policyholders a "fair and equitable" amount for their ownership interests in the company, (2) that the "equity share" of each policyholder be determined under a fair and reasonable formula based upon the insurer's entire surplus as stated in a financial statement filed with the Superintendent, (3) that the conversion plan give each member of the demutualizing insurer a preemptive right to acquire his or her proportionate part of the proposed capital stock of the new stock company, (4) that the plan provide for payment to each member of his or her entire equity share in the insurer, with the payment to be made in cash or stock of the stock company, and (5) that policyholders entitled to receive stock or cash include all policyholders within three years prior to the date the plan was submitted for approval to the Superintendent. *See id.*

On December 14, 1984, Union Mutual submitted a plan of recapitalization and conversion to the Superintendent. Union Mutual amended the plan several times in response to rulings by the Superintendent. On July 11, 1986, Union Mutual submitted its fourth and final amended plan, which was approved by the Superintendent on August 8, 1986.

The approved plan of conversion may be generally described as follows. A holding company was formed to own all the stock of the new stock company. Those who were "eligible policyholders" [2] transferred their "membership interests" in Union Mutual to the holding company in exchange for stock in the holding company. "Membership interests" were defined in the conversion plan as:

> [A]ll the rights or interests of each policy and contract holder of Union Mutual including, but not limited to, any right to vote, any rights which may exist with regard to the surplus of Union Mutual not apportioned by the Board for policyholder dividends, and any rights in liquidation or reorganization of Union Mutual, but shall not include any other right expressly conferred by a policyholder's insurance policy or contract.

Eligible policyholders who qualified as "cash option eligible policyholders" [3] could elect to exchange their membership interests for cash instead of stock. The holding company, after obtaining 100% of the membership interests in Union Mutual, exchanged the membership interests for 100% of the shares of the newly formed stock insurer. The holding company sold stock not issued to policyholders to insiders and the general public. At the conclusion of the Plan, UNUM Life Insurance Co. ("UNUM Life"), the new stock company, was a wholly owned subsidiary of UNUM, the holding company. UNUM was in turn owned by former Union Mutual policyholders, insiders, and members of the general public.

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[2] "Eligible policyholders" were generally defined in the conversion plan as all Union Mutual policyholders during the three years prior to December 31, 1984.

[3] "Cash option eligible policyholders" were generally defined in the conversion plan as policyholders with equity of less than $2,500 in Union Mutual.

The approved plan included an actuarial formula for calculating the consideration to be paid to each policyholder in exchange for his or her membership interest in Union Mutual. This figure, denominated each policyholder's "equity share" in Union Mutual, was defined as "the dollar amount of that part of Union Mutual's Adjusted Surplus attributable to" the particular policyholder. Each policyholder's "equity share" comprised two components: a "minimum equity share" and the individual's "contribution to statutory surplus". On December 31, 1985, the day Union Mutual presented its consolidated balance sheet for final review by the Superintendent, Union Mutual's adjusted surplus was $652,050,097.[4] Based on that figure, Union Mutual's management determined that each policyholder should receive a per capita amount of $612.25 as the "minimum equity share". The "contribution to statutory surplus" varied by individual policyholder. The formula for computing a policyholder's "equity share" that is referred to in the plan of conversion reveals this two-component scheme.

The plan of conversion also provided for creation of an accounting mechanism known as a Participation Fund Account ("PFA"). The PFA created the functional

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[4] Surplus can be measured by either statutory accounting principles or generally accepted accounting principles ("GAAP"). The difference between the two methods is primarily one of timing: the costs of selling policies are fully charged when incurred under statutory accounting principles, but are amortized over the expected life of the policies under GAAP. UNUM's accumulated surplus of $652,050,097 was calculated under GAAP.

In UNUM's demutualization plan, "surplus" was defined as "the amount of the surplus of Union Mutual as shown by its financial statement as of the Computation Record Date (December 31, 1985) filed with the Superintendent, as may be confirmed or adjusted in the event of an examination by the Superintendent, including all voluntary reserves but without taking into account the value of nonadmitted assets or of insurance business in force."

equivalent of a closed block[5] and was allocated assets which, together with premiums from the participating policies, were actuarially sufficient to pay policy claims and policyholders dividends. Under the conversion plan, the amount of the assets in the PFA could not be distributed to stockholders of the demutualized insurer. As with a closed block, it had to be invested and used for the exclusive benefit of the policyholders. The PFA was designed with the aim that Union Mutual's policyholders would continue to receive policyholder dividends after the demutualization at the same level as before, even though policyholders and stockbrokers would have competing claims on the earning and profits of the company. The PFA thus was meant to assure policyholders that their reasonable expectations about the investment value of their policies would continue to be met.

The creation of the PFA was an important consideration in the Superintendent's decision to approve the demutualization plan. In his Final Decision and Order, the Superintendent discussed the PFA at some length, observing that Union Mutual policyholders had bought their policies with an understanding that policy costs would be

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[5] Some states protect the policyholders by requiring that a mutual insurer establish a "closed block" of business as a condition of demutualization. *See* N.Y. Ins. Laws. § 7312 (West 1997); 40 Pa. Cons.Stat. Ann. § 915-A (West 1997). Such statutes generally require the mutual insurer's policies and contracts in force at the time of the reorganization be placed by the reorganized insurer into a "closed block" into which the insurer must allocate assets that, together with revenue, are sufficient to pay policy claims and policyholder dividends. Thereafter, the insurer may not distribute any earnings or proceeds developed within that block to stockholders. The closed block must be operated for the exclusive benefit of the included policies and contracts, distributions being for policyholder dividend purposes only. *See id.*; Dye, *supra* at 115-116.

A PFA may be required as a condition of demutualization in states which do not require a closed block. The Maine demutualization statute does not require a closed block. *See* Me.Rev. Stat. Ann. tit. 24-A, § 3477 (West 1996).

continually adjusted through dividends reflecting Union Mutual's actual experience. The Superintendent also noted that, when purchasing their policies, policyholders based their dividend expectations on dividend illustrations shown to them by Union Mutual that were in turn based on the dividends the company had been paying pursuant to the dividend scales current at the time of purchase. The Superintendent concluded:

> Even though these "illustrations" were not guarantees that dividends would be paid, Union Mutual, in practice, typically paid dividends in accordance with these scales. Based upon these illustrations and upon actual practice, policyholders expect that they will continue to receive these dividends as long as their policies are in force. Therefore, I find it appropriate that the Plan, by creating a mechanism such as the PFA, supports these expectations of future dividends.

That the PFA would maintain these expectations was, according to the Superintendent, critical to the acceptability of the conversion plan.

Union Mutual implemented its plan of conversion on November 14, 1986. To the 105,098 Eligible Policyholders who selected the Cash Option, Union Mutual distributed $129,129,082. To the remaining 58,561 Eligible Policyholders, Union Mutual distributed 20,489,072 shares of UNUM stock. This stock was assessed as having a fair market value of $25.20 per share, making the total value of the UNUM stock distributed under the Plan equal to $522,471,336. Union Mutual also distributed an additional $609,396 in cash to compensate policyholders for the value of fractional shares created by the conversion formula. In total, Union Mutual distributed $652,209,8174 to the Eligible Policyholders during the demutualization.

Prior to the demutualization, on October 12, 1984, Union Mutual's tax counsel had asked the IRS for a pri-

vate letter ruling on the tax treatment of the conversion. Contrary to the position taken by UNUM now, Union Mutual then sought to convince the IRS that the stock distributed to policyholders in exchange for their membership interests in Union Mutual would constitute tax free exchanges under § 351 of the Code. UNUM also sought to persuade the IRS that the exchange of the membership interests received by the holding company for common stock of the new stock company would constitute a tax free recapitalization under § 368(a)(1)(E).

In support of these positions, Union Mutual made a submission to the IRS on March 25, 1985 stating that "the equity interest of Union Mutual's policyholders resemble the rights of stockholders in a corporation and have substantial value." The submission further stated that the Supreme Court, in *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 62 S.Ct. 546, 86 L.Ed. 789 (1942), had characterized a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation," *Id.* at 202, 62 S.Ct. at 552, and argued that "[t]he exchange of *evidences* of ownership interest in Union Mutual argues for the exchange being treated as a recapitalization" under the Supreme Court's characterization. *Id.* (emphasis in original).

Union Mutual made another submission to the IRS on November 8, 1985, discussing whether the exchange of the membership interests for cash or stock would be treated as nondeductible redemptions of stock under § 302 or as deductible "policyholder dividends" under § 808 and § 805, although UNUM did not specifically ask for a letter ruling on that subject at that time.

On December 16, 1986, the IRS issued its private letter ruling to Union Mutual regarding the proper tax treatment of the demutualization. *See* Priv. Ltr. Rul. 87-11-121 (December 16, 1986). The letter ruling stated that the exchange between the policyholders and UNUM

of the policyholders' membership interests in Union Mutual for UNUM stock was a tax-free exchange under § 351. *See id.* The ruling also stated that the exchange between UNUM and UNUM Life, the stock insurer that would succeed Union Mutual, of the Union Mutual membership interests for UNUM Life voting common stock was a tax free recapitalization under § 368(a)(1)(E). *See id.* The ruling further stated that the cash distributed to policyholders in exchange for their membership interests constituted value-for-value transfers and were, accordingly, properly characterized as nondeductible redemptions under § 302, not deductible "policyholder dividends" under § 808 and § 805. *See id.*[6] The IRS viewed the stock-for-membership interest exchanges, in contrast, as non-recognition exchanges subject to § 351 (no gain or loss recognized to policyholders), § 354 (no gain or loss recognized to holding company on exchange of membership interests to converted company for stock), and § 1032 (no gain or loss recognized to either holding company or converted company on receipt of property for stock).

On its 1986 consolidated federal income tax return, UNUM did not claim a "policyholder dividend" deduction for the cash and stock distributed to policyholders during

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[6] The IRS has not always held this view regarding the tax treatment of distributions from surplus made during a demutualization. In 1983, the IRS issued a non-binding technical advice memorandum addressing the demutualization of a mutual casualty insurer through merger with a stock insurer. Tech. Adv. Mem. 8409003 (Nov. 4, 1983). In this memorandum, the IRS took the view now advanced by UNUM that cash distributions paid out of surplus to policyholders during the demutualization were policyholder dividends under then § 822(e)(2) and § 822(c)(11). In 1989, the IRS withdrew this memorandum without comment. Tech. Adv. Mem. 9010003 (Nov. 13, 1989). Because such memoranda are nonbinding, we do not base our conclusions upon them. We nonetheless recognize that the IRS has not consistently maintained the positions it presently advances in this appeal.

the demutualization. UNUM had entered into an agreement with the IRS extending the time period within which the IRS could audit the 1986 return, after which UNUM would be given an additional six months within which to decide whether to amend the return to claim a refund. The IRS audit, which ended in 1991, concluded that UNUM had properly characterized the cash distributions as non-deductible stock redemptions under § 302 and the stock distributions as made pursuant to nonrecognition exchanges of its stock for property. UNUM thereafter changed its view of the proper tax treatment of the transaction by timely amending its 1986 return to claim the cash ($129,738,748), then the value of the stock ($522,471,336), as deductible policyholder dividends under § 808 and § 805. UNUM sought a refund in excess of $77 million. The IRS denied these claimed deductions.

In 1993, UNUM filed suit in the district court, seeking deductions and a refund of the $77 million. The district court ruled in favor of the government, holding that the cash and stock distributions could not be construed as "policyholder dividends" under § 808. UNUM appeals.

II

UNUM makes a colorable but ultimately unpersuasive argument that this appeal involves only the narrow task of interpreting § 808 and § 805 of the Code. UNUM would have at least a plausible argument that it was entitled to a "policyholder dividend" deduction if those two sections were the only potentially relevant Code sections to this case. But we must construe the Code as a whole. The Supreme Court admonished in *Helvering v. N.Y. Trust Co.*, 292 U.S. 455, 54 S.Ct. 806, 78 L.Ed. 1361 (1934), that "the expounding of a statutory provision strictly according to the letter without regard to other parts of the Act and legislative history [may] often defeat the object intended to be accomplished." *Id.* at 464, 54 S.Ct. at 808-09. Therefore, courts must

> not look merely to a particular clause in which general words may be used, but . . . take in connection with it the whole statute (or statutes on the same subject) and the objects and policy of the law, as indicated by its various provisions, and give to it such a construction as will carry into execution the will of the Legislature, as thus ascertained, according to its true intent and meaning.

Id. (citation and internal quotations omitted).

We conclude that § 808 and § 805 do not govern this case. UNUM's demutualization constitutes a capital transaction and is accordingly subject to the general corporate tax rules under Subchapter C which govern such transactions. These rules clearly bar any deduction for amounts distributed during a capital transaction.

A. *Structural Overview*

Because this case involves the interplay between two Subchapters of the Code, we describe them in general terms. Subchapter C is a broadly applicable section of the Code which contains many of the Code's general corporate tax provisions. It applies to all corporations, including mutual and stock insurance companies. *See* § 7701(a)(3) ("When used in this title, . . . [t]he term 'corporation' includes . . . insurance companies."); § 7701 (a)(8) ("the term 'shareholder' includes a member in an . . . insurance company.").

Subchapter C governs corporate capital transactions and the taxation of all corporate distributions and adjustments, including the organization, operation, liquidation, and reorganization of all corporate enterprises and their distributions to shareholders and associates. *See* §§ 301-85. Many general rules in Subchapter C as well as additional

rules in other sections of the Code contain language that, by their literal terms, bar the deduction UNUM seeks. Sections 162, 311, 354, and 1032 apply with particular force. We explain these sections and discuss why they apply later.

Subchapter L, in contrast, is a highly focused section of the Code which specifically governs certain aspects of the taxation of life insurance companies. *See* §§ 801-818. Subchapter L enacts a special scheme of determining the gross income, deductions, and taxable income of life insurance companies, whether of the stock or mutual variety. It accommodates the unique manner by which life insurance companies raise and distribute capital. One purpose behind this parallel system of income calculation is to determine more accurately the taxable income of life insurance companies than general tax rules otherwise would permit.

While Subchapter L applies specifically to life insurance companies, the existence of Subchapter L does not exempt insurance companies from the application of the rest of the Code, Subchapter L at times specifically displaces otherwise applicable rules. For example, life insurance company taxable income is defined in § 801 as "life insurance gross income" reduced by "life insurance deductions". § 801(b). "Life insurance gross income" is specifically defined in § 803, not the generally applicable definition of gross income provided in § 61. And "life insurance deductions" are specifically governed by § 804 and § 805, even though § 804 and § 805 incorporate many of the general rules about deductions by reference. But Subchapter L does not alter general tax rules governing subjects not within its ambit. Specifically, Subchapter L does not exempt insurance companies from the general corporate tax rules of Subchapter C "[e]xcept to the extent that [Subchapter L makes] specific provisions." S.Rep. No. 291, 86th Cong., 1st Sess. 39 (1959), *reprinted in* 1959-2 C.B. 770, 798.

The Supreme Court addressed the relationship between Subchapter C and Subchapter L in *Colonial American Life Ins. Co. v. Commissioner*, 491 U.S. 244, 109 S.Ct. 2408, 105 L.Ed.2d 199 (1989). *Colonial American* involved the question of whether "ceding commissions" paid by a reinsurance company to a direct insurer under an indemnity reinsurance contract could be deducted in the year in which they were paid, or whether they had to be capitalized over the estimated life of the underlying policies. *See id.* at 246-47, 109 S.Ct. at 2411. The taxpayer argued that the ceding commissions were analogous to certain agents' commissions deductible under § 809 and should be similarly deductible. *See id.* at 249-50, 109 S.Ct. at 2412-13. The IRS responded that the ceding commissions were more properly characterized as a type of capital expenditure and should, as is usual for such expenditures, be amortized over their useful life under § 263. *See id.* at 252-53, 109 S.Ct. at 2413-15. The Court ruled against the taxpayer, holding that § 809 did not expressly provide for the requested deduction and that § 263 should apply in the absence of a specific provision to the contrary. *See id.* at 260, 109 S.Ct. at 2418. The taxpayer's argument, the Court stated,

> at most proves only that Congress decided to carve out an exception for agents' commissions, notwithstanding their arguable character as capital expenditures. We would not take it upon ourselves to extend that exception to other capital expenditures, notwithstanding firmly established tax principles requiring capitalization, where Congress has not provided for the extension.

Id. at 252, 109 S.Ct. at 2413-14.

Under the rule of *Colonial American*, general corporate tax provisions of Subchapter C apply to insurance companies unless Subchapter L makes a specific provision to the contrary. The question that this case poses, therefore,

is whether the cash and stock distributions made by UNUM during its conversion are made specifically deductible by § 808 and § 805 of Subchapter L, notwithstanding the fact that they are clearly not deductible under § 162, § 311, § 354, § 1032 and other relevant provisions of the Code.

B. *UNUM's burden of proof*

It is a now "familiar rule" that an income tax deduction " 'is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.' " *INDOPCO, Inc. v. Commisioner*, 503 U.S. 79, 84, 112 S.Ct. 1039, 1043, 117 L.Ed.2d 226 (1992) (quoting *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281-82, 87 L.Ed. 1607 (1943)). Deductions must therefore be "strictly construed" and allowed " 'only as there is clear provision therefor.' " *Id.* (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440, 54 S.Ct. 788, 790-91, 78 L.Ed 1348 (1934)). Subchapter L has been subject to narrow construction because its provisions "give life insurance companies tax benefits over other taxpayers." *National Life & Accident Ins. Co. v. United States*, 385 F.2d 832, 833 (6th Cir.1967). Thus it is UNUM's burden to demonstrate that the cash and stock distributed during the demutualization constitute deductible "policyholder dividends" under § 808.

C. *Analysis of UNUM's arguments*

UNUM's principal argument is that the cash and stock distributions constitute "policyholder dividends" under the plain meaning of § 808, § 808(b)(1) in particular, and are therefore deductible under § 805(a)(3). Bolstering this position are two overlapping contentions: (1) the legislative history and public policy underlying the Code's scheme of life insurance taxation demonstrate that Congress intended the term "policyholder dividend" to include

the distributions made during UNUM's demutualization; and (2) because "policyholder dividends" are broader than classic corporate dividends, "policyholder dividends" need not possess the essential characteristics of a dividend —i.e., they are not subject to the constraints which limit the classic definition of dividends. We reject both arguments.

There is no dispute that § 805(a)(3) allows life insurance companies to deduct "policyholder dividends" from income. Section 805(a)(3) expressly states: "there shall be allowed the following deductions: . . . —The deduction for policyholder dividends . . ." § 805(a)(3). The real question, rather, is whether the definition of "policyholder dividend" in § 808 encompasses the cash and stock distributed during UNUM's demutualization.

In this regard, UNUM's principal argument is that the plain meaning of § 808 entitles it to deduct the amounts distributed during the demutualization.[7] We believe that, in order to make this claim successfully, UNUM must demonstrate that the distributions satisfy both § 808(a) and § 808(b). Section 808(a) provides that:

> [F]or purposes of this part, the term "policyholder dividend" means any dividend or similar distribution to policyholders in their capacity as such.

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[7] Section 808(a) and (b) provide in full:

> (a) Policyholder dividend defined.—For purposes of this part, the term "policyholder dividend" means any dividend or similar distribution to policyholders in their capacity as such.
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> (b) Certain amounts included.—For purposes of this part, the term "policyholder dividend" includes—
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> (1) any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management.
>
> (2) excess interest,
>
> (3) premium adjustments, and
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> (4) experience-rated refunds.

§ 808(a). Under § 808(b)(1), upon which UNUM hinges the main body of its argument, a "policyholder dividend" may include:

> any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management.

§ 808(b).

UNUM asserts that the distributions easily satisfy § 808(a), which, UNUM claims, merely emphasizes the broad scope of "policyholder dividends." The source of UNUM's authority for this claim is unclear. UNUM seems to rely principally on *Republic Nat'l Life Ins. Co. v. United States,* 594 F.2d 530 (5th Cir.1979), in which the court stated that "policyholder dividends" have an "expansive definition" and "include more than just classic dividends." *Id.* at 532. UNUM seems also to rely on Treas. Reg. § 1.811-2(a) (1997), which tracks the language of § 808(a), as further evidence of the broad scope of the "policyholder dividend." Because "policyholder dividends" are "expansive", UNUM argues, they necessarily encompass the amounts distributed during the demutualization. We are not persuaded by these arguments, which attempt to sweep the language of § 808(a) under the table. Rather, we think that § 808(a) presents a major obstacle, which UNUM fails to overcome.

UNUM argues that the real test is whether the distributions satisfy § 808(b). UNUM focuses its attention on the text of § 808(b)(1), arguing: (1) Nothing in the insurance contracts between UNUM and its policyholders addressed the amounts due to the policyholders in a demutualization; therefore the amounts were "not fixed in the contract"; (2) The cash was distributed out of Union Mutual's accumulated surplus, which represents the fruits of the company's considerable business success since its

founding; therefore the amounts "depend[ed] on the experience of the company"; (3) Union Mutual's management, though subject to the supervision of the Maine Superintendent of Insurance and obligated to present "fair and equitable" terms to the policyholder, decided the amounts within that range which would be paid to policyholders in exchange for their equity interests; therefore, the amounts were based "on the discretion of management." The combination of these circumstances, UNUM argues, satisfies the elements of § 808(b)(1) and thus the distributions are "policyholder dividends" deductible under § 805(a)(3), regardless of the general corporate tax provisions contained in Subchapter C.

While we recognize that UNUM's argument is plausible, we nonetheless find it unpersuasive. As we explain later, § 808(b) describes categories of distributions that may constitute policyholder dividends provided that the definition of § 808(a) is met. But UNUM has failed to satisfy us that the term "policyholder dividend" under § 808(a) includes value-for-value exchanges that occur during a corporate reorganization such as this. UNUM's argument ultimately suffers from a fundamental defect: it assumes that Congress wished to ignore the context in which the cash and stock distributions took place. We later explain why UNUM's arguments that the distributions fit within § 808(a) fail. We first set the stage as to why Subchapter C applies.

D. *Application of Subchapter C*

In a paradigmatic recapitalization, the corporation is not allowed a deduction for distributions made in the course of the transaction. *See Woodward v. Commissioner*, 397 U.S. 572, 579 n.8, 90 S.Ct. 1302, 1307 n.8, 25 L.Ed.2d 577 (1970) ("[W]herever a capital asset is transferred to a new owner in exchange for value either agreed upon or determined by law to be a fair quid pro

quo, the payment itself is a capital expenditure . . ."); *United States v. Houston Pipeline Co.*, 37 F.3d 224, 226 (5th Cir.1994) ("Stock redemptions, as a general rule, are characterized as capital transactions, and the purchase price of a stock redemption is not deductible.") (footnotes omitted); *Jim Walter Corp. v. United States*, 498 F.2d 631 (5th Cir.1974) (corporation's purchase of outstanding warrants in connection with issuance of stock and bonds treated as a capital transaction); *Frederick Weisman Co. v. Commissioner*, 97 T.C. 563, 572, 1991 WL 241153 (1991) (collecting cases).

Here, Union Mutual purchased its policyholders' equity interests and transferred them to UNUM. UNUM in turn exchanged the policyholders' membership interests in Union Mutual for stock in UNUM or cash. UNUM was financially in no worse a position after "paying out" $522 million worth of stock to implement the demutualization than it was before the transaction occurred. What changed was the form of ownership, precisely the topic which capital transactions typically involve.[8] As for the $130 million distributed in cash to redeem certain policyholders' interests, UNUM was left poorer. But the Code disallows

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[8] UNUM acknowledged that its demutualization was a capital transaction subject to general corporate tax law when it submitted its May 22, 1985 request to the IRS for a private letter ruling regarding whether the conversion would be entitled to tax-free treatment under § 351 and § 368(a)(1)(E). The IRS treated the demutualization as a capital transaction in its response, *see* Priv. Ltr. Rul. 87-11-121 (Dec. 16, 1986), in which it confirmed that the transaction would be nontaxable under those sections and further stated that the cash distributions would be treated as nondeductible redemptions under § 302 and the stock distributions would be treated as non-recognition exchanges under § 1032. We do not view this as precluding UNUM from changing its position, but that UNUM thought it necessary to ask the IRS for a letter ruling on the general corporate tax implications of its demutualization reflects UNUM's awareness that its restructuring was subject to Subchapter C.

deductions for such distributions made in redemption. *See* § 311(a).

We find that, because UNUM's demutualization is a capital transaction, it is subject to the general corporate tax provisions of Subchapter C unless UNUM carries its burden of showing an exception. These provisions clearly prohibit a company from deducting cash or the value of stock distributed to its policyholders in redemption of their equity interests in the company.

Applying Subchapter C, the Code would clearly disallow UNUM from taking a deduction on the *cash* distributed during the demutualization. Section 311 provides that a corporation that purchases shares of its stock from a shareholder ordinarily may not receive a deduction for that purpose.[9] Section 311(a) states:

> no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of its stock (or rights to acquire its stock), or property.

§ 311(a). Congress reinforced the strength of this rule by enacting § 162(*l*) (now § 162(k)) after the Fifth Circuit recognized a narrow exception in *Five Star Manufacturing Co. v. Commissioner*, 355 F.2d 724 (5th Cir. 1966) (deduction allowed when expenditures made to save the corporation from dire and threatening circumstances). Section 162(k)(1) unreservedly prohibits corporations from taking deductions for distributions made in the course of reacquiring its stock:

> Except as provided in paragraph 2, no deduction otherwise allowable shall be allowed under this chap-

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[9] The Code treats the membership interests held by Union Mutual's policyholders as "stock". *See* § 7701(a)(7) ("the term 'stock' includes shares in an . . . insurance company"). The Code also treated Union Mutual's policyholders as stockholders in a corporation. *See* § 7701(a)(8) ("the term 'shareholder' includes a member in an . . . insurance company.").

> ter for any amount paid or incurred by a corporation in connection with the reacquisition of its stock. . . .[10]

§ 162(k)(1). The reference to "this chapter" is to Chapter One of the Code (I.R.C. §§ 1-1399), which includes both the general corporate tax provisions in Subchapter C and the insurance tax provisions on Subchapter L. While § 162(k)(2) does contain some exceptions to the general rule,[11] none of these apply to insurance companies. By its literal terms, therefore, § 162 forecloses any deduction for the cash distributed by UNUM.[12]

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[10] *Cf.* I.R.C. § 317(b), providing that "[f]or purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock."

[11] Section 162(k)(2) provides that:

> (2) Exceptions.—Paragraph (1) shall not apply to—
>
> (A) Certain deductions.—Any—
>
> (i) deduction allowable under section 162 (relating to interest)
>
> (ii) deduction for amounts which are properly allocable to indebtedness and amortized over the term of such indebtedness, or
>
> (iii) deduction for dividends paid (within the meaning of section 561)
>
> (B) Stock of certain regulated investment companies—Any amount paid or incurred in connection with the redemption of any stock in a regulated investment company which issues only stock which is redeemable upon the demand of the shareholder.

The "dividends paid" deduction under § 561 does not include policyholder dividends, but only includes dividends as described in § 316 "relating to [the] definition of dividends for purposes of corporate distributions". § 562(a).

[12] The legislative history of § 162 supports the conclusion that § 162(k) forecloses a deduction for UNUM in this case. The Committee Report suggests that Congress intended § 162(*l*) (now § 162(k)) to be construed broadly to foreclose any deduction for

The Code is equally clear that UNUM may not deduct the value of the *stock* distributed in exchange for equity interests. Section 354(a) provides

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan or reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

§ 354(a). Section 354 thus bars any deduction for the exchange of UNUM stock for the membership interests of Union Mutual pursuant to the conversion plan. And § 1032(a) provides

> No gain or loss shall be recognized to a corporation on the receipt of money or property in exchange for stock (including treasury stock) of such corporation.

§ 1032(a). As is the case with § 162(k) and § 311, these Code sections do not contain provisions excluding insurance companies from their scope.

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payments in connection with redemptions, except for those specifically enumerated in the statute.

> The conferees intend that the denial of deductibility will apply to amounts paid in connection with a purchase of stock in a corporation, whether paid by the corporation directly or indirectly, e.g., by a controlling shareholder, commonly controlled subsidiary or related party.
>
> The conferees wish to clarify that, while the phrase "in connection with [a] redemption" is intended to be construed broadly, the provision is not intended to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time or arising out of the same general circumstances.

H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess at II-168, *reprinted in* 1986 U.S.C.C.A.N. 4075, 4256. In this case, there is a clearly established nexus in that the payment "does . . . represent consideration for the [membership interests] or expense related to [their] acquisition. . . ." *Id.* at 4257.

E. *Section 808*

We find nothing in § 808 that specifically overrides these general rules. Indeed, that § 808 does not even *mention* these rules suggests that it may have nothing to do with capital transactions altogether.

Congress has been explicit in those situations when it wished Subchapter L to modify Subchapter C. *See* § 805 (b) (modifying the interest deduction under § 163, the charitable contributions deduction under § 170, the rules for amortizable bond premium under § 171, the net operting loss deduction under § 172, and the dividends received deductions under §§ 243-245). Congress could have done the same with the Code sections that directly govern UNUM's demutualization. That Congress did not choose to do so strongly suggest that Congress wanted those sections to apply with full force.

Our view that Congress did not intend the demutualization process to be exempted from these general tax rules is strengthened when we examine § 808(a). UNUM essentially makes a two-step argument regarding § 808(a): (1) any distribution which fits the strict language of § 808(b) is a "policyholder dividend" for purposes of § 808, regardless of the language of § 808(a): and (2) because the transaction here is a "policyholder dividend" under § 808, UNUM is entitled to a deduction under § 805(a)(3). We reject the first prong, so the second collapses accordingly.

UNUM argues that the term "polyholder dividend" under § 808 is not bound by the constraints that usually characterize dividends, but includes any distribution that can fit within the language of § 808(b)(1): "any amount paid or credited . . . where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management." We reject this reading of § 808.

Basic canons of statutory construction require us to consider the language of § 808(a) in construing § 808(b).

See United States Nat'l Bank of Or. v. Indep. Ins. Agents of America, Inc., 508 U.S. 439, 455, 113 S.Ct. 2173, 124 L.Ed.2d 402 (1993) (Courts must "at a minimum . . . account for a statute's full text, language as well as punctuation, structure, and subject matter."). Section 808(a) states:

> For purposes of this part, the term "policyholder dividend" means any dividend or similar distribution to policyholders in their capacity as such.

§ 808(a). This text may be divided into three components. The "[f]or the purposes of this part" language requires that the definition of "policyholder dividend" has no force beyond Part I of Subchapter L, which specifically involves the taxation of life insurance companies; thus § 808 cannot govern a transaction basically within the purview of Subchapter C. The "any dividend or similar distribution" language requires all "policyholder dividends" to possess the essential characteristics of a dividend. Finally, the "to policyholders in their capacity as such" requires that the dividend-like distributions be based on the contractual relationship between the policyholder and insurer. We interpret the language of § 808(a) to mean exactly what it says. Any distribution by an insurer to its policyholders must accordingly bear the essential characteristics of a dividend and be based on the contractual relationship between the policyholder and insurer in order to qualify as a "policyholder dividend". And if § 808(a) is not satisfied, then § 808(b) cannot be satisfied either.

UNUM attempts to circumvent the plain meaning of § 808(a) by arguing that the language of § 316 specifically exempts "policyholder dividends" from the constraints that bind typical corporate dividends. Section 316(a) defines the term "dividend" as follows.

> For the purposes of this subtitle, the term "dividend" means any distribution of property made by a cor-

> poration to its shareholders . . . out of its earnings and profits of the taxable year. . . .

§ 316(a). By its terms, this definition of dividends applies to Subtitle A, 26 U.S.C. §§ 1-1563, which includes the portion of the Code governing income taxation. Section 316(b) limits the extent of the application of this definition:

> The definition in subsection (a) shall not apply to the term 'dividend' as used in Subchapter L in any case where the reference is to dividends of insurance companies paid to policyholders as such.

§ 316(b). UNUM argues that the language of § 316(b) demonstrates that "policyholder dividends" have broader scope than "dividends" as defined in § 316(a), so it would be erroneous to conclude that policyholder dividends should be deemed a type of dividend as that term is so defined. It is true that § 316(b) means that a policyholder dividend under § 808 is not limited to distributions out of the insurer's earnings and profits and may include additional amounts from other sources. But, UNUM's assertion notwithstanding, it does not follow that because "policyholder dividends" may include more than classic corporate dividends then "policyholders dividends" may therefore encompass any distribution to policyholders regardless of its context or purpose.[13] As Judge Carter appropriately noted,

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[13] UNUM cites dicta in *Republic Nat'l Life Ins. Co. v. United States*, 594 F.2d 530, 532 (5th Cir.1979), describing the "policyholder dividend" as "expansive." Because policyholder dividends are "expansive," UNUM argues, policyholder dividends can encompass even value-for-value exchanges that occur during a corporate recapitalization. This argument misapprehends the meaning of *Republic Nat'l Life*. In that case, the court was referring to the fact that the definition of "policyholder dividend" is expansive relative to the "classic dividend" definition, adding that "Congress intended to include more than just classic dividends" within policyholder dividends. *Id.*

> The fact that "policyholder dividend" is, in certain respects, broader in scope than "classic dividend" neither implies, nor even suggests, that Congress intended "policyholder dividends" to be construed broadly.

UNUM Corp. v. United States, 929 F.Supp. 15, 20 n. 6 (D. Maine 1996). Indeed, the term "policyholder dividend" is still a defined category. That it possesses a broader scope than the term "dividend" as defined in § 316(a) suggests only that policyholder dividends are different from ordinary corporate dividends, not that they are fundamentally unlike them.

F. *The distributions are not dividends*

This analysis suggests that the lengthy debate as to whether and how policyholder dividends are like or unlike corporate dividends is largely beside the point. All dividends, whether policyholder dividends or corporate dividends, share certain essential characteristics. The focus should be on whether the stock and cash distributions bear the essential characteristics which qualify them as a dividend of any stripe. We find that the cash and stock distributions at issue in this case simply are not "policyholder dividends" as that term is defined, because they are fundamentally not dividends or distributions similar to dividends as § 808(a) requires. Because they do not meet the definition of § 808(a), § 808(b) is superfluous. Moreover, because the distributions do not meet the definition of § 808(a), they are still subject to the general corporate tax rules of Subchapter C, under which they may not be deducted.[14]

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[14] While the holding in this case would be the same whether or not there was a PFA, the existence of the PFA is added evidence that the economic reality of this transaction is that the conversion of mutual membership interests to stock is not a policyholder dividend. The PFA, a crucial element in the decision of the Maine Insurance Commissioner to approve this transaction, is an accounting

The economics of the demutualization compel this conclusion. A dividend, even a policyholder dividend, is a unilateral distribution by a company to its owners (who, in the case of mutual life insurance companies, also happen to be customers). No matter how large, a dividend still leaves intact the owner's equity interest in the company. But the cash and stock distributions for which UNUM seeks a deduction were not unilateral distributions by a company to its owners. Both were made in exchange for policyholders' membership interests in the former mutual company. Those who received cash had their equity interests extinguished, transactions amounting to classic redemptions. Those who received stock had their equity converted from one form to another, transactions which were classic non-recognition exchanges. No authority exists supporting the proposition that the term "dividend" encompasses such transactions.

UNUM nevertheless argues that the distributions should still be characterized as "policyholder dividends" because, removed from context, they can plausibly be shoe-horned into the text of § 808(b)(1). Judge Carter deftly explained the fallacy of UNUM's argument as follows:

> The fact that Congress intended life insurers to be able to deduct any dividend-like distribution to policyholders to the extent of its capital-like component neither implies, nor even gives rise to the inference, that Congress also intended life insurers to be able to deduct any distribution at all to policyholder that contains a capital-like component to the extent of that component.

UNUM Corp. v. United States, 929 F.Supp. at 24 n. 15.

UNUM's argument clouds the reason why § 316 distinguishes policyholder from regular corporate dividends.

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mechanism which recognizes (in the common sense of the word) that policyholder dividend expectations may be segregated from other ownership interests and the two are not equivalent.

Policyholder dividends typically include a capital component in addition to earnings and Congress wished to provide a deduction for that component. *See* § 805(a)(3); § 809 (limiting the extent of the deduction). But the fact that "policyholder dividends" may include additional components does not change the fact that they must still essentially constitute dividends as § 808(a) expressly requires. The acknowledgement reflected in § 316(b) that policyholder dividends are more expansive than classic dividends does not alter this conclusion.

As the district court observed, UNUM's bootstrapping argument ignores other sources of authority on what constitutes a "dividend." In *Hellmich v. Hellman*, 276 U.S. 233, 48 S.Ct. 244, 72 L.Ed. 544 (1928), the Supreme Court described a dividend as

> the recurrent return upon stock paid to stock holders by a going corporation in the ordinary course of business, which does not reduce their stock holdings and leaves them in a position to enjoy future returns upon the same stock.

Id. at 237, 48 S.Ct. at 245. Similarly, the Supreme Court in *United States v. Davis*, 397 U.S. 301, 90 S.Ct. 1041, 25 L.Ed.2d 323 (1970), described a "dividend" as a distribution whose

> effect is to transfer the property from the company to its shareholders without a change in the relative interest or rights of the stockholders.

Id. at 313, 90 S.Ct. at 1048 (emphasis added). A distribution is "not essentially equivalent to a dividend" if it "result[s] in a meaningful reduction of the shareholder's proportional interest in the corporation." *Id.* In light of this authority, we do not view distributions of stock or cash by a mutual insurer in consideration for the same value of ownership interest in a mutual company to be a dividend under any definition of the term, including a "policyholder dividend" under § 808.

The cash distribution is not a dividend or similar to a dividend precisely because it did reduce (to zero) the ownership interest of those policyholders who received cash and left them in no position to enjoy future returns, except as policyholders. *Cf. Hellmich*, 276 U.S. at 237, 48 S.Ct. at 245-46. It was thus akin to a nondeductible distribution in redemption. In contrast, the stock distribution was not a dividend or similar to a dividend because it was not in the nature of a "recurrent return upon stock paid to stockholders by a going corporation in the ordinary course of business." *Id.* Rather, it effected a conversion of one form of equity to another through a classic non-recognition exchange.

G. *Other reasons*

The fact that UNUM's demutualization occurred through a holding company suggests additional reasons why UNUM is also not, for other reasons, entitled to a "policyholder dividend" deduction. First, UNUM, which distributed its stock to policyholders in exchange for their membership interests in Union Mutual, is not a "life insurance company" as defined in § 816(a); the tax consequences of the stock distributions are accordingly subject to general corporation tax provisions in Subchapter C, which disallow the deduction. *See* § 354(a); § 1032(a). Second, the term "amount paid" in § 808(b)(1) requires distributions out of the company's surplus, whereas the stock distribution came from the holding company. Union Mutual did not actually "pay" anything in making that exchange. It is true that UNUM is the sole owner of a life insurance company, but having structured the demutualization as it did, UNUM must "accept the tax consequences of [its] choice." *See Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149, 94 S.Ct. 2129, 2137, 40 L.Ed.2d 717 (1974).[15]

[15] The one aspect of the demutualization involving the stock of a life insurance company was the transaction between the new

Even so, our decision does not rely on the fact that UNUM structured its demutualization through a holding company. Sections 354(a) and 1032(a) would apply to the demutualization regardless of its form, even if Union Mutual distributed stock in the new stock company in direct exchange for the membership interests of its policyholders.

UNUM's best argument may be the analogy it draws between a mutual insurance company liquidation and demutualization. When a mutual insurance company is liquidated, its assets are distributed to the policyholders and those distributions may be called dividends. This reorganization, the company says, is functionally equivalent to such a liquidation because Union Mutual no longer exists on completion of the demutualization. There are two responses. The first is that the analogy does not work. The very nature of a demutualization fundamentally distinguishes it from a liquidation in that the insurer is still in business after the conversion is complete. In the present case, the policyholders continue to be provided insurance, albeit through a different form of company and under a different name. Indeed, ensuring that Union Mutual would continue to meet its policyholders' reasonable expectations on the investment value of their policies was the very purpose of the PFA, which calculated the amount of assets necessary to pay policy claims, provide policyholder dividends, and satisfy whatever other benefits accrued to policyholders under their insurance contracts. Notably, the Maine Insurance Commissioner gave his blessing to the transaction only on being assured there

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stock life insurer, UNUM Life, and the holding company, UNUM, in which the stock company exchanged 100% of its shares for 100% of the membership interest in Union Mutual. A transaction between two corporations can not come within the rubric of § 808, which involves distributions to "policyholders in their capacity as such." Instead, it constitutes a recapitalization under § 368(a)(1)(E), as the IRS confirmed, in response to UNUM's request, in Priv. Ltr. Rul. 87-11-121.

was sufficient capital preserved, together with premiums, to cover the insured risks in the future. This does not happen in the usual liquidation and, indeed, demonstrates that UNUM's demutualization cannot properly be so characterized.

Secondly, even if the analogy were apt in general, we have little reason to think Congress intended that final distributions of all assets to be within the definition of "policyholder dividends" under § 808(a). Congress could easily have provided for this deduction by enacting specific language to that effect. Had Congress wanted to provide insurance companies with a "policyholder dividend" deduction for any distribution to policyholders not fixed in the contract, it could simply have defined "policyholder dividend" as referring to "any distribution." It would not have limited the definition to "dividends or similar distributions" and then left it to the insurance industry to discover massive deductions in the shadows of the statute.

Although we think the plain meaning of § 808 works against, and not for, UNUM, and mindful of the usual rule that resort to legislative history is inappropriate in such circumstances, we do briefly explain UNUM's policy and legislative history argument. Our primary purpose in so doing is to determine whether there is a clearly expressed legislative intention which would cause us to question application of the usual rule. *INS v. Cardoza-Fonseca,* 480 U.S. 421, 432 n. 12, 107 S.Ct. 1207, 1214, n.12, 94 L.Ed.2d 434 (1987). A secondary reason is to note that UNUM's policy arguments are not implausible; they simply do not carry UNUM's burden of showing clearly that Congress intended such a deduction.

In support of its statutory argument, UNUM offers an extended account of the legislative history and public policy behind the Code's scheme of life insurance company taxation. UNUM argues that Congress specifically created the "policyholder dividend" deduction to equalize

the tax treatment of mutual insurers relative to stock insurers. Under general tax rules, stock companies are not taxed on capital raised by selling stock, but may not deduct amounts paid to redeem that stock. (No tax, no deduction) At the same time, mutual insurers must pay income tax on capital raised by charging redundant premiums; but absent the policyholder dividend deduction, they may not deduct amounts paid to return capital to policyholders, which typically occur through policyholder dividends. (Tax, but no corresponding deduction) By creating the policyholder dividend deduction in § 805 (a)(3), UNUM explains, Congress intended to create symmetry in the taxation of mutual insurers and thus provide equal tax treatment for both mutual and stock insurers.

UNUM emphasizes the expansiveness of "policyholder dividends" by contrasting them with a "return premium". Return premiums are refunds that occur when a policy is cancelled, where the amount of the refund generally represents that portion of paid premiums not applied to the purchase of coverage up to the time of cancellation. Robert A. Keeton & Alan I. Widiss, *Insurance Law: A Guide to Fundamental Principles, Legal Doctrines, & Commercial Practices* § 5.11(d)(2) (1988). UNUM explains that these amounts are "fixed in the contract" in that they are based on the terms of the contract. "Policyholder dividends" are, in contrast, any amounts not fixed in the contract, i.e., any distributions from surplus (that depend on the experience of the company or the discretion of management) that are not return premiums.

Under Subchapter L, UNUM explains, Congress divided amounts returned to policyholders into the categories of "return premiums" and "policyholder dividend". Return premiums are deductible, because they contain a return of premiums. Policyholder dividends are also deductible, because, like return premiums, they are in part returns of capital. Policyholder dividends are only de-

ductible in part, however, because they can also contain earnings from the investment of the premiums which are nondeductible under general tax law.

To account for this, UNUM argues, Congress created an expansive definition of "policyholder dividend" in § 808 and enacted § 809 to control the extent of the deduction, since the expansive language does not admit limitation. UNUM claims that § 809 is the sole mechanism by which policyholder dividends should be limited, not through judicial construction of the scope of the definition of "policyholder dividend" under § 808. Policyholder dividends should be, in effect, any distribution that a mutual insurer makes to policyholders out of surplus for any reason, and only the terms of § 809 limit the reach of the deduction.

UNUM argues that the facts that Congress created the policyholder dividend deduction to achieve a tax symmetry and that Congress accordingly defined "policyholder dividend" to possess broad scope necessarily compels the conclusion that "policyholder dividends" must even include distributions to policyholders that are fundamentally not dividends. We believe this conclusion is unsupported by the text or policies underlying the statute. UNUM's analysis of the legislative history and public policy underlying the insurance tax provisions of the Code suffers from the same flaw that undermines its statutory argument. Nothing UNUM cites supports the proposition that Congress intended the term "policyholder dividends" to encompass value-for-value exchanges occurring during a corporate reorganization. UNUM's argument fails not because it relies on erroneous facts, but rather because those facts simply do not support the conclusions UNUM wishes to draw.

In the end, the mere fact that "policyholder dividends" are not "fixed" by the terms of an insurance contract does not mean that they include any distribution that a mutual

insurer makes to its policyholders in any capacity. Under § 808(a), in order for a distribution to qualify as a "policyholder dividend", the distribution must occur to policyholders "in their capacity as such"—i.e., in their capacity as policyholders, not owners. The distribution must also fundamentally be a "dividend or similar distribution." For the reasons explained in the balance of the opinion we believe that the cash and stock distributions made by UNUM were not dividends. Rather, the cash distribution constituted a nondeductible distribution in redemption, while the stock distribution was part of a nonrecognition exchange.

III

In *Colonial American*, the Supreme Court faced a case similar to this one. As here, the taxpayer made a colorable argument that Subsection L provided for tax treatment that general tax law otherwise prohibited. Similarly, the IRS responded that the basic policies and structure of the Code defeated the taxpayer's argument. The Supreme Court, explaining its decision in favor of the IRS, stated:

> It cannot be denied that the language on which petitioner relies, taken in isolation, could be read to authorize the tax treatment it seeks. . . . But when the statutory and regulatory language is parsed more carefully, petitioner's position becomes dubious, and when the language is read against the background of the statutory structure, it becomes untenable.

Colonial American, 491 U.S. at 257, 109 S.Ct. at 2417. We believe the same to be true in this case. To accept UNUM's arguments "we would have to conclude that Congress subsumed a major deduction within the fine details of its definition" of the policyholder dividend. *Id.* at 260, 109 S.Ct. at 2418. We do not believe that Congress intended to conceal in § 808 a deduction of this magnitude.

INDOPCO requires a taxpayer to carry the burden of proof that it is entitled to a claimed deduction. Despite UNUM's arguments, we do not believe that § 808 and § 805 apply to value-for-value exchanges as occurred in this insurance company demutualization.

We affirm the judgment of the district court. Costs to appellees.

APPENDIX B

UNITED STATES DISTRICT COURT
D. MAINE

Civil No. 93-369-P-C

UNUM CORPORATION and UNUM LIFE INSURANCE COMPANY OF AMERICA,
Plaintiffs,

v.

UNITED STATES OF AMERICA,
Defendant.

May 23, 1996

MEMORANDUM OF DECISION AND ORDER

GENE CARTER, Chief Judge.

Plaintiffs UNUM Corporation ("UNUM Corp.") and UNUM Life Insurance Company of America ("UNUM America") sue Defendant United States of America ("the Government" or "the IRS") seeking a tax deduction valued at approximately eighty million dollars. Plaintiffs claim that the cash and stock distributed to their policyholders pursuant to Plaintiffs' Plan of Recapitalization and Conversion, Stipulated Record (Docket No. 42) Ex. 16 ("the Plan"), constitute "policyholder dividends" as defined in § 808 of the Internal Revenue Code, 26 U.S.C.

§ 1 *et seq.* ("the Code" or "I.R.C."), and so are deductible from income pursuant to § 805(a)(3) of the Code. Having denied Defendant's Motion for Summary Judgment, Memorandum and Order Denying Defendant's Motion for Summary Judgment (Docket No. 40), the Court now considers this case for final decision on a stipulated record. *See* Stipulated Record (Docket No. 42) ("Record"). For the reasons discussed below, the Court will find that neither the cash distribution nor the stock distribution constitutes a "policyholder dividend" and, therefore, that neither distribution is deductible from Plaintiffs' income.

I. FACTS

Union Mutual Life Insurance Company ("Union Mutual") was organized as a mutual insurance company in Maine in 1848. Record Ex. 31. At all times relevant to this action, Union Mutual was engaged in the business of writing various forms of life insurance, health and accident insurance, and annuity products. *Id.* ¶ 1. As with mutual companies generally, Union Mutual had no outstanding capital stock and so was not owned by stockholders. *Id.* ¶ 4. As with mutual insurance companies generally, Union Mutual was owned, instead, by its participating policyholders. *Id.* Ex. 8 at 6, Ex. 12 at 15.

Union Mutual's participating policyholders owned the company by virtue of having contributed to Union Mutual's surplus by paying premiums that exceeded the actuarial cost of their policy coverage. Plaintiffs' Trial Brief (Docket No. 44) at 4-5, 18-19 ("Plaintiffs' Brief"); United States' Trial Brief (Docket No. 43) at 3-4 ("Government's Brief"); Record Ex. 8 at 6, Ex. 12 at 15. These excess amounts functioned in a way analogous to the capital raised when a stock insurer makes an offering of its stock. Plaintiffs' Brief at 12-13; Plaintiffs' Reply Brief (Docket No. 45) at 5; Government's Brief at 3-4. Accordingly, in proportion to that contribution to surplus,

each Union Mutual policyholder had certain rights analogous to those of a stockholder, such as voting rights and preemptive rights upon conversion. Plaintiffs' Brief at 18-19; Government's Brief at 3-4; Record Ex. 4 at 5; Plan at A-2.

Taken as a whole, the surplus to which Union Mutual policyholders contributed represented the sum of all revenues in excess of the amount paid or accrued for benefits, reserves, dividends, taxes, and other expenses. Record ¶ 7. As such, Union Mutual's surplus also provided the source from which policyholder dividends were drawn in an amount determined by Union Mutual management on an annual basis. *Id.* Ex. 8 at 6.

As of December 31, 1985, Union Mutual had accumulated surplus, determined on the basis of generally accepted accounting principles ("GAAP"), in the amount of $652,050,097 ("GAAP Surplus"). *Id.* ¶ 9.

A. Formulation of the Recapitalization and Conversion

In December 1984, Union Mutual submitted its initial Plan of Recapitalization and Conversion, Record Ex. 9 ("Initial Plan"), to the Maine Superintendent of Insurance for approval. Record ¶ 15, 16. The Initial Plan detailed a transaction whereby Union Mutual would convert from a mutual insurer to a stock insurer that would be wholly-owned by a new holding company. *See* Initial Plan. The approval process was directed at ensuring that the Initial Plan complied with Maine law governing such a conversion. *See* 24-A M.R.S.A. § 3477. To that end, between June 1985 and July 1986, the Superintendent issued two legal rulings regarding the Initial Plan, and the Union Mutual Board of Directors amended the Initial Plan four times. Record ¶¶ 17-22, Exs. 10-15. Finally, on August 8, 1986, the Superintendent issued a Final Decision and Order approving the final version of the Plan. *Id.* ¶ 24, Ex. 17.

Among other things, the final Plan provides that "[i]n exchange for their Membership Interests, Eligible Policyholders will receive Conversion Stock or cash, all as described in Part VII of this Plan." Plan at A-4. Part VII, entitled "Subscription Offering," begins as follows:

> A. *Eligible Policyholders.*
>
> 1. *Equity Share.* In order to determine the consideration to be provided to Eligible Policyholders in exchange for their Membership Interests, an amount equal to the Adjusted Surplus of Union Mutual shall be allocated among such Eligible Policyholders in accordance with the formulas [provided elsewhere in the Plan for calculating each Eligible Policyholder's Equity Share]. Each Eligible Policyholder's allocation as so determined shall be that Eligible Policyholder's Equity Share.

Plan at A-4. Eligible Policyholders would receive their Equity Share in the form of Conversion Stock unless they qualified as "Cash Option Eligible Policyholders," in which case, they could choose to receive the same Equity Share in the form of cash. Plan at A-1, A-5. Moreover, once Eligible Policyholders thus exchange their Membership Interests for their Equity Shares (whether in stock or cash) of the Adjusted Surplus, "present and past policy and contract holders will have no Membership Interests in Union Mutual." Plan at A-4.

The Plan also provides three particularly important definitions, which this Court hereby adopts, for terms used above to describe the transaction. First, "Membership Interest" is defined as:

> all rights and interests of each policy and contract holder of Union Mutual including, but not limited to, any right to vote, any rights which may exist with regard to the surplus of Union Mutual not apportioned

> by the Board for policyholder dividends, and any rights in liquidation or reorganization of Union Mutual, but shall not include any other right expressly conferred by a policyholder's insurance policy or contract.

Plan at A-3. Second, "Equity Share" is defined as "the dollar amount of that part of Union Mutual's Adjusted Surplus attributable to that Eligible Policyholder on the basis of the formulas [provided elsewhere in the Plan for calculating Equity Share.]" Plan A-1. Third, "Adjusted Surplus" is defined as "the amount of surplus as of December 31, 1985 . . . [as determined] in accordance with generally accepted accounting principles. . . ." Plan at A-1.

Maine law requires such a conversion plan to be approved by at least two-thirds of those policyholders who vote on it. *See* 24-A M.R.S.A. § 3477(2)(B). The Plan was approved by ninety-eight percent of those Eligible Policyholders who voted on it. Record ¶ 29.

B. Execution of the Recapitalization and Conversion

The following series of transactions (collectively "Recapitalization and Conversion") occurred on or about November 14, 1986, the effective date of the Plan. Record ¶ 32. Union Mutual disbursed $129,129,082 in cash by check to the 105,098 Cash Option Eligible Policyholders who chose to exercise that option. *See id.* Ex. 24, ¶ 33. Union Mutual charged this entire amount against its statutory and GAAP surplus. *Id.* ¶ 34.

Union Mutual amended its charter both to convert the company from a mutual insurer to a stock insurer and to change the company name to UNUM Life Insurance Company ("UNUM Life"). *Id.* ¶¶ 5, 31, 32.

UNUM Life delivered all 6,000,000 of its newly-minted shares of stock to the new holding company, UNUM Corp.

Id. ¶¶ 35, 36, Ex. 22. "[I]n consideration for" those 6,000,000 shares of UNUM Life stock, UNUM Corp. issued 20,489,072[1] shares of UNUM Corp. stock to the remaining 58,561 Eligible Policyholders. *Id.* ¶ 37, Ex. 22, 24. At a fair market value of $25.50 per share on the effective date, the total value of the UNUM Corp. Conversion Stock distribution to those Eligible Policyholders was $522,471,336. *Id.* ¶ 38, Ex. 24.

In addition, to the extent that the value of the Equity Share of those 58,561 Eligible Policyholders exceeded the value of a whole number of UNUM Corp. shares by the value of some fractional share, Union Mutual distributed to those Eligible Policyholders an additional $609,396 in cash to represent the value of those fractional shares. *See Id.* Ex. 24, ¶ 33.[2]

By the conclusion of the Recapitalization and Conversion, 163,659 Eligible Policyholders had received distributions of cash and stock in the amount of $652,209,814.[3] *Id.* Ex. 24, ¶ 45.

C. Taxation of the Recapitalization and Conversion

The process of determining the federal tax consequences of the Recapitalization and Conversion began on October

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[1] This finding of fact is based upon the parties' stipulation that UNUM Corp. distributed 20,489,072 shares of its own stock to Eligible Policyholders as part of the Recapitalization and Conversion. Record Ex. 24. This Court disregards other indications in the record that 20,508,915 shares were issued. *See id.* Ex. 22.

[2] In addition to the above distributions to Eligible Policyholders, the Recapitalization and Conversion involved other transactions, including the sale of UNUM Corp. stock at $25.50 per share to employees and to the general public, as well as the investment of capital by UNUM Corp. in subsidiaries of the former Union Mutual. Record ¶¶ 34, 41.

[3] This total exceeds GAAP Surplus by less than one-twentieth of one percent because of distributions made after November 14, 1986, but before December 31, 1986, to a small number of belatedly identified Eligible Policyholders. *See* Record Ex. 24.

12, 1984, over two years before the effective date of the Plan, when Union Mutual's tax counsel submitted a request for a letter ruling to the IRS. Record ¶ 11, Ex. 4. In that request, Union Mutual sought to convince the IRS that the distribution of UNUM Corp. stock in exchange for Membership Interests in Union Mutual constituted a tax-free exchange under I.R.C. § 351, and that the conversion of those Membership Interests into UNUM Life stock constituted a tax-free recapitalization under I.R.C. § 368(a)(1)(E). *Id.* Ex. 4 at 22, 24.

During the years 1984 through 1986, Union Mutual's tax counsel made numerous additional submissions to the IRS pertaining to the initial request. *Id.* ¶ 11, Ex. 5. One such submission, dated November 8, 1985, discussed the issue of whether the distribution of cash in exchange for Membership Interests should be treated as a "redemption" in exchange for Membership Interests under I.R.C. § 302 or as a "policyholder dividend" under I.R.C. § 808 but did not request a letter ruling on that issue. *Id.* Ex. 5.

On December 16, 1986, the IRS issued its letter ruling to Union Mutual regarding the Recapitalization and Conversion. Record ¶ 12, Ex. 6 ("Letter Ruling"). The Letter Ruling agreed with Union Mutual's characterization of the stock distribution as a tax-free exchange under § 351 and of the conversion as a tax-free recapitalization under § 368(a)(1)(E). Letter Ruling at 9, 11. The Letter Ruling added that the cash distribution should be treated as a "redemption" under § 302 rather than a "policyholder dividend" under § 808. Letter Ruling at 12.

Beginning with the taxable year ending December 31, 1986, UNUM Life joined in the filing of a life-nonlife consolidated tax return with its parent, UNUM Corp., and with its other affiliates. Record ¶ 48. The original federal income tax return filed for that year did not seek a deduction for any part of the cash or stock distributed pursuant to the Plan. *Id.* ¶ 49, Ex. 25. Since then, UNUM Life has merged with and into UNUM Life In-

surance Company of America ("UNUM America"), which remains Union Mutual's surviving corporate successor and a wholly-owned subsidiary of UNUM Corp. *Id.* ¶¶ 53, 54, 56.

On May 15, 1992, current Plaintiffs, UNUM Corp. and UNUM America, timely filed refund forms claiming that the cash ($12,738,478) distributed to Eligible Policyholders pursuant to the Plan on its effective date was deductible as a "policyholder dividend" under I.R.C. §§ 805(a)(3) and 808. *Id.* ¶ 50, Ex. 26. On September 25, 1992, Plaintiffs timely filed refund forms claiming that the fair market value of the UNUM Corp. stock ($552,471,336) distributed to Eligible Policyholders pursuant to the Plan on its effective date was deductible as a "policy-holder dividend" under I.R.C. §§ 805(a)(3) and 808. *Id.* ¶ 51, Ex. 27.

On March 12, 1993, the IRS sent a letter to Plaintiffs proposing to disallow the refund claims. *Id.* ¶ 52. On December 29, 1993, after protesting this proposed disallowance administratively through the IRS Appeals Office, Plaintiffs filed this suit to obtain the refunds. *Id.* ¶ 52; *see* Complaint (Docket No. 1).

II. DISCUSSION

The dispositive issue in this case[4] is whether the Recapitalization and Conversion distributions of cash and UNUM Corp. stock to former Union Mutual policyholders fall within the definition of "policyholder dividend"

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[4] In the course of opposing Plaintiffs' contentions, the Government claims that the cash distributions constitute redemptions under I.R.C. § 302 and that the stock distributions constitute exchanges under I.R.C. § 351. *See* Government's Brief at 19-23. It is not necessary to reach the Government's claims regarding §§ 302 and 351 in order to address the dispositive issue, *i.e.*, whether the cash and stock distributions constitute "policyholder dividends" under I.R.C. § 808. Therefore, the Court wil not reach the Government's claims regarding §§ 302 and 351.

contained in I.R.C. § 808 and are, therefore, deductible under I.R.C. § 805(a)(3).[5] The Court finds that neither the cash nor the stock distribution constitutes a "policyholder dividend" for two reasons: (1) neither distribution is a "dividend or similar distribution" as required by § 808(a); and (2) the amount of neither distribution "depends on the experience of the company or the discretion of the management" as required by § 808(b)(1).

A. Structural Overview

The analysis must begin by identifying the applicable provisions of the Internal Revenue Code and describing the relationship among those provisions.

Subchapter C of the Code applies to all corporations, which include insurance companies. *See* I.R.C. §§ 301, 7701(a)(3). Among those insurance companies to which subchapter C applies are life insurance companies, both stock and mutual. *See Duffy v. Mutual Benefits Life Ins. Co.*, 272 U.S. 613, 616, 47 S.Ct. 205, 205, 71 L.Ed. 439 (1926). Subchapter L also applies to insurance companies. *See* I.R.C. § 801. Among those insurance companies to which subchapter L applies are life insurance companies, both stock and mutual. *See* I.R.C. §§ 801-818.

Subchapter C, then, governs the taxation of life insurance companies, both stock and mutual, "[e]xcept to the extent that [subchapter L makes] specific provision." H.R.Rep. No. 34, 86th Cong., 1st Sess. (1959), *reprinted in* 1959-2 C.B. 736, 750; S.Rep. No. 291, 86th Cong., 1st Sess. (1959), *reprinted in* 1959-2 C.B. 770, 798. Such specific provisions of subchapter L are construed

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[5] Section 805(a)(3) of the Code provides:

§ 805. General Deductions

(a) General rule.—For purposes of this part, there shall be allowed the following deductions:

(3) Policyholder dividends.—The deduction for policyholder dividends (determined under section 808(c)).

narrowly because they bestow tax benefits on insurers not generally available to other taxpayers. *Nat'l Life and Accident Ins. Co. v. United States*, 385 F.2d 832, 833 (6th Cir.1967). Moreover, provisions defining the scope of a deduction, regardless of their location in the Code, are construed strictly. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84, 112 S.Ct. 1039, 1042-43, 117 L.Ed.2d 226 (1992). Finally, "the burden of clearly showing the right to the claimed deduction is on the taxpayer," for "an income tax deduction is a matter of legislative grace." *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281, 87 L.Ed. 1607 (1943).

The specific provision here at issue, the § 808 definition of a deductible "policyholder dividend," appears in subchapter L and defines the scope of a deduction. This Court, therefore, will construe the definition of "policyholder dividend" strictly.[6] Such a strict construction of

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[6] Plaintiffs labor mightily to characterize the "policyholder dividend" deduction as so clearly intended by Congress to be construed broadly as to exempt it from the application of the ordinary canons of statutory construction discussed above. First, Plaintiffs cite dicta describing an earlier definition of "policyholder dividend" as "expansive." *Republic Nat'l Life Ins. Co. v. United States*, 594 F.2d 530, 532 (5th Cir.1979). There, the court was referring to the fact that the "policyholder dividend" definition was "expansive" in relation to the "classic dividend" definition, adding that "Congress intended to include more than just classic dividends" within policyholder dividends. *Id.* The fact that "policyholder dividend" is, in certain respects, broader in scope than "classic dividend" neither implies, nor even suggests, that Congress intended "policyholder dividend" to be construed broadly. Second, Plaintiffs point to the "any amount" language of § 808(b)(1) as an indication of the atypical breadth of this deduction. The "any amount" language, however, indicates only that any dollar value may be deducted: it does *not* indicate that any type of distribution may be deducted. In fact, § 808(b)(1) only describes one particular subtype of "policyholder dividend," and so should be read as subject to the general definition of "policyholder dividend" in § 808(a) that requires all "policyholder dividends" to be dividend-like. *See infra* Section II.B. Therefore, there is no warrant for excepting the

this specific provision of subchapter L will correspondingly displace the operation of subchapter C only very little. Finally, Plaintiffs may not prevail unless they meet their burden of proving clearly that the distributions fall within that narrow deduction.

It is within this broader framework that the Court now examines the precise language of § 808.

B. Is Either Distribution a "Dividend or Similar Distribution" Under § 808(a)?

Section 808(a) defines a "policyholder dividend" as "any dividend or similar distribution to policyholders in their capacity as such." I.R.C. § 808(a).[7] The parties to this action differ primarily over the meaning of "any dividend or similar distribution." Plaintiffs largely avoid addressing the meaning of this statutory language and thereby implicitly treat it as if it has no limiting effect on the scope of the term "policyholder dividend." *See* Plaintiffs' Brief at 19-20. The Government, by contrast, dedicates most of its trial brief to the claim that it is precisely this language that operates to exclude the present distributions from the "policyholder dividend" deduction. *See* Government's Brief at 10-26.

1. Is Either Distribution a "Dividend"?

"Dividend" is the first salient disputed term in the § 808(a) definition. Subchapter L itself provides no defi-

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"policyholder dividend" deduction from ordinary canons of statutory construction that indicate the propriety of reading deductions narrowly.

[7] Section 808(a) of the Code provides:

> § 808. Policyholder dividends deduction
>
> (a) Policyholder dividend defined.—For purposes of this part, the term "policyholder dividend" means any dividend or similar distribution to policyholders in their capacity as such.

nition of the term "dividend" specific to that subchapter. Subchapter C, however, does provide a definition for all of subtitle A, which includes subchapter L. I.R.C. § 316(a).[8] Section 316(a) defines "dividend," in relevant part, as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits of the taxable year." *Id.*

Section 316(b)(1), however, expressly prohibits the application of the language of § 316(a) to subchapter L and, therefore, to § 808(a). I.R.C. § 316(b)(1).[9] Still, the language of § 316(a) does not exhaustively describe all limits on the meaning of "dividend"; other sources of

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[8] Section 316(a) of the Code provides:

§ 316. Dividend defined

(a) General rule.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

[9] Section 316(b)(1) of the Code provides:

§ 316. Dividend defined

(b) Special rules.—

(1) Certain insurance company dividends.—The definition in subsection (a) shall not apply to the term "dividend" as used in subchapter L in any case where the reference is to dividends of insurance companies paid to policyholders as such.

law also help define the scope of the term. *See, e.g., Hellmich v. Hellman*, 276 U.S. 233, 236-37, 48 S.Ct. 244, 245-46, 72 L.Ed. 544 (1928). Section 316(b)(1), then, prohibits *only* the application of the language of § 316(a) to limit the meaning of "dividend"; § 316(b)(1) does not prohibit the application of those other sources of law that also help define the scope of the term.[10] Therefore, in light of § 316(b)(1), all sources of law, except for the language of § 316(a), that help define the scope of the term "dividend" as it is used outside subchapter L also help define the scope of "dividend" as it is used within subchapter L, including § 808(a).[11]

What, then, are those residual constraints on the meaning of "dividend"? In *Hellmich v. Hellman*, 276 U.S. 233,

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[10] Indeed § 316(b)(1) *cannot* prohibit the application of other sources of law that help define "dividend" without thereby reading the term (and, consequently, "or similar") entirely out of the § 808(a) definition of "policyholder dividend." To read "dividend" as limitless in scope in the phrase "any dividend or similar distribution" is to read the phrase instead as "any distribution." Although amending the statute in this way apparently is Plaintiffs' desire, it plainly is not Congress's intent. *See* Plaintiffs' Brief at 30-31; Plaintiffs' Reply Brief at 2.

[11] This reading of the relationship among § 316(a), § 316(b)(1), and § 808(a) comports well with Congress's understanding of the substantive economic content of "policyholder dividends." Congress expects "policyholder dividends" to include not only earnings and profits, but a component analogous to a return of capital. *American Mut. Life Ins. Co. v. United States*, 43 F.3d 1172, 1173 (8th Cir. 1994); *see Republic Nat'l Life Ins. Co. v. United States*, 594 F.2d 530, 536 n. 21 (5th Cir.1979) (quoting legislative history). Indeed, policyholder dividends are deductible precisely because they contain that capital-like component and precisely to the extent of that component. *See* I.R.C. §§ 808(c)(2), 809. If, however, § 316(a) restrictions remained applicable to the term "dividend" in § 808(a), "policyholder dividends" would include only earnings and profits, thus excluding the targeted deductible capital-like component. Therefore, § 316(b)(1) allows the § 808(a) definition of "policyholder dividend" to include that deductible capital-like component without relaxing any other restrictions on the term "dividend."

48 S.Ct. 244, 72 L.Ed. 544 (1928), the Supreme Court applied two sources of law other than the language of the predecessor of § 316(a) to define "dividend." The *Hellmich* court first invoked case law reflecting the common usage of "dividend," describing it as:

> the *recurrent* return upon stock paid to stock holders by a going corporation *in the ordinary course of business*, which *does not reduce their stock holdings* and *leaves them in a position to enjoy future returns upon the same stock*.

Id. at 237, 48 S.Ct. at 245 (emphasis added). The Court then read the statutory provision defining affirmatively what a liquidation distribution *is* as also defining negatively what a dividend distribution *is not*. *Id.* Specifically, dividends are distinguishable from liquidations in that only the latter involve "a return to the stockholder of the value of his stock upon a surrender of his interest in the corporation." *Id.* at 235, 48 S.Ct. at 245.

Similarly, in *United States v. Davis*, 397 U.S. 301, 90 S.Ct. 1041, 25 L.Ed.2d 323 (1970), the Court discussed the meaning of "dividend" in the context of another Code provision, again without reference to § 316(a). There, the Court described a "dividend" as a distribution whose "effect is to transfer the property from the company to its shareholders without a change in the relative economic interests or rights of the stockholders." *Id.* at 313, 90 S.Ct. at 1048. The court concluded, in turn, that a distribution is "not essentially equivalent to a dividend" if it "result[s] in a meaningful reduction of the shareholder's proportionate interest in the corporation." *Id.; see Bradbury v. Commissioner*, 298 F.2d 111, 115 (1st Cir.1962) (affirming that dividends do not change shareholders' proportionate interests in the corporation).

In light of these authorities, it comes as no surprise that Plaintiffs have not produced any case, statute, regulation, or other legal authority defining the term "dividend" as a distribution to a shareholder made in exchange

for a substantial reduction, not to mention a complete surrender, of the shareholder's proportional interest in the company.[12] Nor have Plaintiffs produced any such authority defining the term "dividend" as a distribution to a shareholder made in exchange for *any* form of property of equivalent value, proportional shareholder interest or otherwise.[13]

The term "dividend" in the § 808(a) definition of "policyholder dividend," then, does not include either of

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[12] The closest semblance of contrary legal authority Plaintiffs produce is disputed expert opinion that "termination dividends" are made to policyholders in exchange for the surrender of all their proportional interests in the insurance company. Plaintiffs' Brief at 31-32. For several reasons, this opinion does not constitute valid contrary legal authority. First, expert opinion on a matter of law bears little, if any, persuasive authority, particularly when binding authorities, such as those discussed above, militate strongly against the opinion. Second, at least one expert denies that "termination dividends" are made *in exchange for* surrendering all proportional interests in the company. Deposition of Ralph J. Sayre, January 26, 1995, at 191. Instead, he affirms only that most "termination dividends" are made *upon the occasion of* surrendering proportional interests in the company. *Id.* at 192-93. Moreover, he denies that "termination dividends" represent the economic value of those surrendered proportional interests, or that "termination dividends" are distributed to compensate for, or to induce, the surrender of those interests. *Id.* at 48, 191. Third, the term "termination dividend" is not the term "dividend," but a term of art that may or may not be defined as a species of "dividend." (In other words, it may be defined in part as "any distribution, regardless of similarity to a dividend," just as Plaintiffs would define "policyholder dividend.") Therefore, even if "termination dividends" were distributions made in exchange for the surrender of all proportional interests in the company, that fact has no demonstrated relevance to whether "dividends" may be distributions made in exchange for the surrender of all proportional interests in the company.

[13] In fact, in exchange transactions between a noncorporate shareholder and a corporation, property the shareholder receives from the corporation is not even taxed as a distribution except to the extent that its value exceeds the value of the property the shareholder gives to the corporation. *See* Treas.Reg. § 1.301-1(j).

the distributions here at issue. Both the cash and stock distributions were made to Eligible Policyholders in exchange for the complete surrender of all their proportional interests in the former Union Mutual. Both the cash and stock distributions were made to Eligible Policyholders in exchange for property of equivalent value, namely, their Membership Interests in the former Union Mutual. Therefore, neither type of distribution may be considered a "dividend" for purposes of § 808(a).

2. Is Either Distribution a "Similar Distribution"?

Having determined that the "any dividend" language of § 808(a) does not include the present distributions, the question remains whether the "or similar distribution" language does. This language appears to broaden the meaning of "policyholder dividend" beyond the already broadened meaning of "dividend" discussed above.[14] If the "or similar distribution" language broadens "policyholder dividend," at all, however, it does so only in small measure given how narrowly both deduction provisions and subchapter L provisions should be read. *See supra* Section II.A.

The remaining question under § 808(a), then, is whether the "or similar distribution" language broadens "policyholder dividend" enough to include the distributions at issue. More precisely, the remaining question is whether Plaintiffs have met their burden to show clearly that Congress intended that a distribution that is dissimilar to a "dividend," both because it is made in exchange for complete surrender of a shareholder's proportional interest in a company and because it is made in exchange for property of equivalent value, nevertheless remains sim-

[14] The "or similar distribution" language, however, may be read not to broaden the meaning of "dividend" at all. Instead, it may simply emphasize and reinforce the more precise broadening function of § 316(b)(1): to indicate that the term "dividend" in subchapter L is not limited to earnings and profits.

ilar enough to a "dividend" to warrant the special tax treatment of a deductible "policyholder dividend." That question must be answered in the negative.

Plaintiffs make no attempt to show that the distribution in this case are similar to a "dividend" in any way, least of all similar in such a way and to such an extent as to warrant their inclusion among those distributions Congress clearly intended for deductibility. Rather than acknowledge the limiting effects of the "any dividend or similar distribution" language of § 808(a), Plaintiffs dwell on the capital structure of mutual insurance companies, the value of symmetry in taxation, and the economic content of actual policyholder dividends.[15] *See Penn. Mut.*

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[15] The error underlying Plaintiffs' lengthy argument, by which they ignore the letter of § 808(a) but appeal to what they consider its spirit, may be stated comparatively briefly. The fact that Congress intended life insurers to be able to deduct *any dividend-like distribution* to policyholders to the extent of its capital-like component neither implies, nor even gives rise to the inference, that Congress also intended life insurers to be able to deduct *any distribution at all* to policyholders that contains a capital-like component to the extent of that component. Contrary to Plaintiffs contention, this Court does not consider the intention to limit the deduction only to dividend-like distributions so irrationally asymmetric and unfair that it should not be imputed to Congress. *See* Plaintiffs' Brief at 33-34; Plaintiffs' Reply Brief at 14-15. It is far from unfair for Congress to tax as income to mutual companies their capital-like funds upon receipt and then to allow a corresponding deduction for those funds upon distribution only when they are measured out in a certain form. (To be sure, Congress is free to allow no deduction at all.) Instead, limiting the deduction only to dividend-like distributions may be said to perform any number of legitimate purposes. One such purpose may be what Plaintiffs accurately identify as the purpose of certain provisions of previous regimes governing the deductibility of "policyholder dividends"—simply to limit life insurers' ability to use the deduction. Plaintiffs' Brief at 6-7, 10. Another such purpose may be to ensure the application to insurance companies, stock and mutual alike, of those provisions of subchapter C applying to all other companies, stock and mutual alike, that govern the taxation of certain distributions that are not dividend-like, such as distributions constituting re-

Life Ins. Co. v. Lederer, 252 U.S. 523, 527, 40 S.Ct. 397, 398, 64 L.Ed. 698 (1920). Accordingly, Plaintiffs do not even begin to carry their burden of showing that these distributions fit within the limits of that statutory language and, therefore, within the limits of Congress's intent to allow the deduction. Neither the cash nor the stock distribution in this case, then, constitutes a deductible "policyholder dividend" because neither meets the "any dividend or similar distribution" requirement of § 808(a).

C. *Does the Amount of Either Distribution "Depend[] on the Experience of the Company or the Discretion of the Management" Under § 808(b)(1)?*

Not only are the distributions in this case not "dividends or similar distributions" under § 808(a), they do not fall within any of the four subcategories of distribution specifically enumerated in § 808(b) as included among "policyholder dividends." Plaintiffs argue only that the distributions fit within the first of these categories, described in § 808(b)(1), which includes "any amount . . . [that] is not fixed in the contract but depends on the experience of the company or the discretion of the management." I.R.C. § 808(b)(1).[16] This Court finds that § 808(b)(1) does not include the present distributions because, although their amounts are not fixed in the con-

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demptions and exchanges. *See supra* Section II.A.; I.R.C. §§ 302(b)(3), 351(a). Notwithstanding Plaintiffs' contention, then, this Court infers the spirit of § 808(a) to be in harmony with its letter and gives effect to both.

[16] Section 808(b)(1) of the Code provides:

> § 808. Policyholder dividends deduction
>
> (b) Certain amounts included.—For purposes of this part, the term "policyholder dividend" includes—
>
> (1) any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management.

tract, their amounts do not depend on the experience of the company or the discretion of the management.

1. Is the Amount of Either Distribution "Fixed in the Contract"?

Plaintiffs first contend that the amounts of the distributions in this case are "not fixed in the contract." A distribution amount is 'fixed in the contract" when policy contract provisions both fix the distribution amount, such as by formula, and legally oblige the insurance company to make the distribution. *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222, 1227 (8th Cir. 1987). There are no policy contract provisions governing the distribution amounts in this case. This Court, therefore, finds that those distribution amounts are "not fixed in the contract."

Plaintiffs then argue that this Court's finding that the distribution amounts are "not fixed in the contract" suffices alone to include the distributions within § 808(b)(1), for that finding implies a corresponding finding that the distribution amounts either "depend[] on the experience of the company or the discretion of the management." Plaintiffs' Reply Brief at 9. In support of this argument, Plaintiffs cite *dicta* from *American National Insurance Co. v. United States*, 690 F.2d 878 (Ct.Cl.1982), suggesting that these latter two elements of the § 808(b)(1) definition "may not have independent significance" and "seem to be opposite sides of the same coin, in the sense that the inquiry is whether the amounts are either fixed in the contract or depend upon [experience or discretion]." *Id.* at 886.

This Court is not persuaded to read these latter two elements of the § 808(b)(1) definition out of the statute by needlessly denying their "independent significance." Indeed, far from being superfluous, the question of whether the amount depends on company experience or management discretion constitutes the primary inquiry

under § 808(b)(1).[17] The subsidiary inquiry of whether the amount is fixed in the contract facilitates, but cannot substitute entirely for, the primary inquiry; the subsidiary inquiry serves only to exclude from the primary inquiry an easily identified category of distributions that invariably fail the primary inquiry.

In other words, if a distribution amount is "fixed in the contract," it categorically cannot "depend[] on the experience of the company or the discretion of the management." If, however, a distribution amount is "*not* fixed in the contract," it may or may not "depend[] on the experience of the company or the discretion of the management." Only certain distributions have their amounts "fixed in the contract"; within the otherwise boundless residual category (*i.e.*, "not fixed in the contract"), only certain distributions depend on either company experience or management discretion.

The *American National* court's *dicta*, then, were appropriate to the facts before it because the distributions there were fixed in the contract. *See American Nat'l*, 690 F.2d at 886 ("Since we hold that the amounts . . . were fixed by the contract, it follows that they did not depend upon the experience of the company or the discretion of the management.") Those *dicta*, by contrast, are not appropriate to the facts before this Court because the amounts here are *not* fixed in the contract. Therefore, the questions of whether the distribution amounts depend on company experience or on management discretion remain open. This Court now turns to those questions.

---

[17] The clearest indication of the indispensability and primacy of the company-experience-or-management-discretion inquiry is Congress's use of the conjunctive "but" to introduce it. To accept Plaintiffs' reading of that inquiry as dispensable and equivalent to the not-fixed-in-the-contract inquiry is effectively to amend that conjunctive "but" to the disjunctive "or."

2. Does the Amount of Either Distribution "Depend[] on the Experience of the Company"?

Plaintiffs claim that the amounts of both distributions "depend on the experience of the company." "Experience of the company" refers only to company-specific profit and loss experience, not industry-wide actuarial experience. *Republic Nat'l Life Ins. Co. v. United States*, 594 F.2d 530, 534-35 (5th Cir.1979). More specifically, the relevant profit and loss experience is limited to the company's "experience in the particular year for which the refunds are made, not its overall past experience and history." *American Nat'l*, 690 F.2d at 886. Here, the distribution amounts are based on Union Mutual's profit and loss experience for the entire history of the company since 1848, not for the particular year in which the distributions are made. Therefore, the distribution amounts do not depend on the "experience of the company."

3. Does the Amount of Either Distribution "Depend[] . . . on the Discretion of the Management"?

Plaintiffs argue, in the alternative, that the distribution amounts in this case "depend on the discretion of the management." The term "discretion of the management" does not include the limited form of discretion that management necessarily exercises in designing any general formula for fixing distribution amounts. *American Nat'l*, 690 F.2d at 887. Here, that limited form of discretion is the only form that Union Mutual's management could even colorably have exercised. Indeed, the decisionmaking power of Union Mutual's management regarding the formula for determining Equity Shares is so thoroughly circumscribed that it can hardly be called "discretion" at all. More specifically, the design of the formula, along with the rest of the Plan, was subject both to the requirements of Maine insurance law as implemented by the Maine Superintendent of Insurance and to a supermajority vote

of policyholders. *See* Plan at A-3. The distribution amounts, therefore, do not depend on the "discretion of the management." Nor, then, do the distributions fit within § 808(b)(1).

III. CONCLUSION

Section 808 defines "policyholder dividend" as "any dividend or similar distribution to policyholders in their capacity as such," including "any amount paid or credited . . . [that] is not fixed in the contract but depends on the experience of the company or the discretion of the management." I.R.C. §§ 808(a), 808(b)(1). Plaintiffs urge this Court to read that definition, in effect, as "any distribution to policyholders that is not fixed in the contract," while the Government urges that it be read as "any dividend-like distribution to policyholders that depends on company experience or management discretion, which categorically does not include those fixed in the contract." This Court finds that the Government's interpretation of "policyholder dividend" provides a more nearly comprehensive account of all relevant statutory language, and so provides a more nearly adequate account of the intention that Congress sought to embody in that language.

This Court further finds that the distributions of cash and stock in this case do not fit within the reading of "policyholder dividend" accepted by the Court. Those distributions are not "dividend-like" both because policyholders obtained them in exchange for property of equivalent value and because policyholders obtained them in exchange for the surrender of all their proportional interests in Union Mutual. Because the distribution amounts are not "fixed in the contract," the question of whether they "depend on company experience or management discretion" is not summarily answered in the negative. That question is ultimately answered in the negative, however, because the distributions do not fall within the meaning of "company experience" or "management discretion" as

those terms have been interpreted. Therefore, neither the cash nor the stock distribution is deductible to Plaintiffs under § 805(a)(3).

Accordingly, it is hereby *ORDERED* that judgment herein be, and it is hereby, *ENTERED* in favor of the Defendant, United States of America, on all claims set forth in the Complaint.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 96-1877

UNUM CORPORATION AND UNUM LIFE INSURANCE COMPANY OF AMERICA,
Plaintiff, Appellant,

v.

UNITED STATES OF AMERICA,
Defendant, Appellee.

JUDGMENT
Entered: December 2, 1997

This cause came on to be heard on appeal from the United States District Court for the District of Maine, and was argued by counsel.

Upon consideration whereof, it is now here ordered, adjudged and decreed as follows: The judgment of the district court is affirmed. Costs of appellees.

BY THE COURT:

/s/ Phoebe Morse
PHOEBE MORSE
Clerk

By: /s/ _____
Chief Deputy Clerk

APPENDIX D

SUPREME COURT OF THE UNITED STATES
OFFICE OF THE CLERK
WASHINGTON, DC 20543-0001

WILLIAM K. SUTER
Clerk of the Court

Area Code 202
479-3011

February 5, 1998

Mr. John G. Roberts Jr.
Hogan & Hartson
555 Thirteenth Street, N.W.
Washington, DC 20004

Re: UNUM Corporation and UNUM Life Insurance Company of America
v. United States
Application No. A-572

Dear Mr. Roberts;

The application for an extension of time within which to file a petition for a writ of certiorari in the above-entitled case has been presented to Justice Souter, who on February 5, 1998, extended the time to and including April 16, 1998.

This letter has been sent to those designated on the attached notification list.

Sincerely,

WILLIAM K. SUTER
Clerk

By /s/ Jeffrey D. Atkins
JEFFREY D. ATKINS
Assistant Clerk

APPENDIX E

PERTINENT STATUTORY AND REGULATORY PROVISIONS

26 U.S.C. § 118(a) provides:

Contributions to the capital of a corporation

(a) General rule.—In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

* * * *

26 U.S.C. § 316 provides in pertinent part:

Dividend defined

(a) General rule.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) Special rules.—

(1) Certain insurance company dividends.—The definition in subsection (a) shall not apply to the term "dividend" as used in subchapter L in any case

where the reference is to dividends of insurance companies paid to policyholders as such.

* * * *

26 U.S.C. § 803 provides:

Life insurance gross income

(a) In general.—For purposes of this part, the term "life insurance gross income" means the sum of the following amounts:

(1) Premiums.—

(A) The gross amount of premiums and other consideration on insurance and annuity contracts, less

(B) return premiums, and premiums and other consideration arising out of indemnity reinsurance.

(2) Decreases in certain reserves.—Each net decrease in reserves which is required by section 807(a) to be taken into account under this paragraph.

(3) Other amounts.—All amounts not includible under paragraph (1) or (2) which under this subtitle are includible in gross income.

(b) Special rules for premiums.—

(1) Certain items included.—For purposes of subsection (a)(1)(A), the term "gross amount of premiums and other consideration" includes—

(A) advance premiums,

(B) deposits,

(C) fees,

(D) assessments,

(E) consideration in respect of assuming liabilities under contracts not issued by the taxpayer, and

(F) the amount of policyholder dividends reimbursable to the taxpayer by a reinsurer in respect of reinsured policies,

on insurance and annuity contracts.

(2) Policyholder dividends excluded from return premiums.—For purposes of subsection (a)(1)(B)—

(A) In general.—Except as provided in subparagraph (B), the term "return premiums" does not include any policyholder dividends.

(B) Exception for indemnity reinsurance.—Subparagraph (A) shall not apply to amounts of premiums or other consideration returned to another life insurance company in respect of indemnity reinsurance.

* * * *

26 U.S.C. § 805 provides:

General deductions

(a) General rule.—For purposes of this part, there shall be allowed the following deductions:

(1) Death benefits, etc.—All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts.

(2) Increases in certain reserves.—The net increase in reserves which is required by section 807(b) to be taken into account under this paragraph.

(3) Policyholder dividends.—The deduction for policyholder dividends (determined under section 808(c)).

(4) Dividends received by company.—

(A) In general.—The deductions provided by section 243, 244, and 245 (as modified by subparagraph (B))—

(i) for 100 percent dividends received, and

(ii) for the life insurance company's share of the dividends (other than 100 percent dividends) received.

(B) Application of section 246(b).—In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of subparagraph (A), the limit on the aggregate amount of the deductions allowed by sections 243(a)(1), 244(a), and 245 shall be the percentage determined under section 246(b)(3) of the life insurance company taxable income (and such limitation shall be applied as provided in section 246(b)(3)), computed without regard to—

(i) the small life insurance company deduction,

(ii) the operations loss deduction provided by section 810,

(iii) the deductions allowed by sections 243(a)(1), 244(a), and 245, and

(iv) any capital loss carryback to the taxable year under section 1212(a)(1),

but such limit shall not apply for any taxable year for which there is a loss from operations.

(C) 100 percent dividend.—For purposes of subparagraph (A)—

(i) In general.—Except as provided in clause (ii), the term "100 percent dividend" means any dividend if the percentage used for purposes of determining the deduction allowable under section 243, 244, or 245(b) is 100 percent.

(ii) Treatment of dividends from non-insurance companies.—The term "100 percent dividend" does not include any distribution by a corporation which is not an insurance company to the extent such distribution is out of tax-exempt interest, or out of the increase for the taxable year in policy cash values (within the meaning of subparagraph (F)) of life insurance policies and annuity and endowment contracts to which section 264(f) applies, or out of dividends which are not 100 percent dividends (determined with the application of this clause as if it applies to distributions by all corporations including insurance companies).

(D) Special rules for certain dividends from insurance companies.—

(i) In general.—In the case of any 100 percent dividend paid to any life insurance company out of the earnings and profits for any taxable year beginning after December 31, 1983, of another life insurance company if—

(I) the paying company's share determined under section 812 for such taxable year, exceeds

(II) the receiving company's share determined under section 812 for its taxable year in which the dividend is received or accrued,

the deduction allowed under section 243, 244, or 245(b) (as the case may be) shall be reduced as provided in clause (ii).

(ii) Amount of reduction.—The reduction under this clause for a dividend is an amount equal to—

(I) the portion of such dividend attributable to prorated amounts, multiplied by

(II) the percentage obtained by subtracting the share described in subclause (II) of clause (i) from the share described in subclause (I) of such clause.

(iii) Prorated amounts.—For purposes of this subparagraph, the term "prorated amounts" means tax-exempt interest, the increase for the taxable year in policy cash values (within the meaning of subparagraph (F)) of life insurance policies and annuity and endowment contracts to which section 264(f) applies, and dividends other than 100 percent dividends.

(iv) Portion of dividend attributable to prorated amounts.—For purposes of this subparagraph, in determining the portion of any dividend attributable to prorated amounts—

(I) any dividend by the paying corporation shall be treated as paid first out of earnings and profits for taxable years beginning after December 31, 1983, attributable to prorated amounts (to the extent thereof), and

(II) by determining the portion of earnings and profits so attributable without any reduction for the tax imposed by this chapter.

(v) Subparagraph to apply to dividends from other insurance companies.—Rules similar to the rules of this subsection shall apply in the case of 100 percent dividends paid by an insurance company which is not a life insurance company.

(E) Certain dividends received by foreign corporations.—Subparagraph (A)(i) (and not subparagraph (A)(ii)) shall apply to any dividend received by a foreign corporation from a domestic corporation which would be a 100 percent dividend if section 1504(b)(3) did not apply for purposes of applying section 243 (b)(2).

(F) Increase in policy cash values.—For purposes of subparagraphs (C) and (D)—

(i) In general.—The increase in the policy cash value for any taxable year with respect to policy or contract is the amount of the increase in the adjusted cash value during such taxable year determined without regard to—

(I) gross premiums paid during such taxable year, and

(II) distributions (other than amounts includible in the policyholder's gross income) during such taxable year to which section 72(e) applies.

(ii) Adjusted cash value.—For purposes of clause (i), the term "adjusted cash value" means the cash surrender value of the policy or contract increased by the sum of—

(I) commissions payable with respect to such policy or contract for the taxable year, and

(II) asset management fees, surrender charges, mortality and expense charges, and any other fees or charges specified in regulations prescribed by the Secretary which are imposed (or which would be imposed were the policy or contract canceled) with respect to such policy or contract for the taxable year.

(5) Operations loss deduction.—The operations loss deduction (determined under section 810).

(6) Assumption by another person of liabilities under insurance, etc., contracts.—The consideration (other than consideration arising out of indemnity reinsurance) in respect of the assumption by another person of liabilities under insurance and annuity contracts.

(7) Reimbursable dividends.—The amount of policyholder dividends which—

(A) are paid or accrued by another insurance company in respect of policies the taxpayer has reinsured, and

(B) are reimbursable by the taxpayer under the terms of the reinsurance contract.

(8) Other deductions.—Subject to the modification provided by subsection (b), all other deductions allowed under this subtitle for purposes of computing taxable income.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this part in respect of policyholder dividends.

(b) Modifications.—The modifications referred to in subsection (a)(8) are as follows:

(1) Interest.—In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 807(c).

(2) Charitable, etc., contributions and gifts.—In applying section 170—

(A) the limit on the total deductions under such section provided by section 170(b)(2) shall be 10 percent of the life insurance company taxable income computed without regard to—

(i) the deduction provided by section 170,

(ii) the deductions provided by paragraphs (3) and (4) of subsection (a),

(iii) the small life insurance company deduction,

(iv) any operations loss carryback to the taxable year under section 810, and

(v) any capital loss carryback to the taxable year under section 1212(a)(1), and

(B) under regulations prescribed by the Secretary, a rule similar to the rule contained in section 170(d)(2)(B) (relating to special rule for net operating loss carryovers) shall be applied.

(3) Amortizable bond premium.—

(A) In general.—Section 171 shall not apply.

(B) Cross reference.—

For rules relating to amortizable bond premium, see section 811(b).

(4) Net operating loss deduction.—Except as provided by section 844, the deduction for net operating losses provided in section 172 shall not be allowed.

(5) Dividends received deduction.—Except as provided in subsection (a)(4), the deductions for dividends received provided by sections 243, 244, and 245 shall not be allowed.

* * * *

26 U.S.C. § 808 provides:

Policyholder dividends deduction

(a) Policyholder dividend defined.—For purposes of this part, the term "policyholder dividend" means any dividend or similar distribution to policyholders in their capacity as such.

(b) Certain amounts included.—For purposes of this part, the term "policyholder dividend" includes—

(1) any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management.

(2) excess interest,

(3) premium adjustments, and

(4) experience-rated refunds.

(c) Amount of deduction.—

(1) In general.—Except as limited by paragraph (2), the deduction for policyholder dividends for any taxable year shall be an amount equal to the policyholder dividends paid or accrued during the taxable year.

(2) Reduction in case of mutual companies.—In the case of a mutual life insurance company, the deduction for policyholder dividends for any taxable year shall be reduced by the amount determined under section 809.

(d) Definitions.—For purposes of this section—

(1) Excess interest.—The term "excess interest" means any amount in the nature of interest—

(A) paid or credited to a policyholder in his capacity as such, and

(B) in excess of interest determined at the prevailing State assumed rate for such contract.

(2) Premium adjustment.—The term "premium adjustment" means any reduction in the premium under an insurance or annuity contract which (but for the reduction) would have been required to be paid under the contract.

(3) Experience-rated refund.—The term "experience-rated refund" means any refund or credit based on the experience of the contract or group involved.

(e) Treatment of policyholder dividends.—For purposes of this part, any policyholder dividend which—

(1) increases the cash surrender value of the contract or other benefits payable under the contract, or

(2) reduces the premium otherwise required to be paid,

shall be treated as paid to the policyholder and returned by the policyholder to the company as a premium.

(f) Coordination of 1984 fresh-start adjustment with acceleration of policyholder dividends deduction through change in business practice.—

(1) In general.—The amount determined under paragraph (1) of subsection (c) for the year of

change shall (before any reduction under paragraph (2) of subsection (c)) be reduced by so much of the accelerated policyholder dividends deduction for such year as does not exceed the 1984 fresh-start adjustment for policyholder dividends (to the extent such adjustment was not previously taken into account under this subsection).

(2) Year of change.—For purposes of this subsection, the term "year of change" means the taxable year in which the change in business practices which results in the accelerated policyholder dividends deduction takes effect.

(3) Accelerated policyholder dividends deduction defined.—For purposes of this subsection, the term "accelerated policyholder dividends deduction" means the amount which (but for this subsection) would be determined for the taxable year under paragraph (1) of subsection (c) but which would have been determined (under such paragraph) for a later taxable year under the business practices of the taxpayer as in effect at the close of the preceding taxable year.

(4) 1984 fresh-start adjustment for policyholder dividends.—For purposes of this subsection, the term "1984 fresh-start adjustment for policyholder dividends" means the amounts held as of December 31, 1983, by the taxpayer as reserves for dividends to policyholders under section 811(b) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1984) other than for dividends which accrued before January 1, 1984. Such amounts shall be properly reduced to reflect the amount of previously nondeductible policyholder dividends (as determined under section 809(f) as in effect on the day before the date of the enactment of the Tax Reform Act of 1984).

(5) Separate application with respect to lines of business.—This subsection shall be applied sepa-

rately with respect to each line of business of the taxpayer.

(6) Subsection not to apply to mere change in dividend amount.—This subsection shall not apply to a mere change in the amount of policyholder dividends.

(7) Subsection not to apply to policies issued after December 31, 1983.—

(A) In general.—This subsection shall not apply to any policyholder dividend paid or accrued with respect to a policy issued after December 31, 1983.

(B) Exchanges of substantially similar policies.—For purposes of subparagraph (A), any policy issued after December 31, 1983, in exchange for a substantially similar policy issued on or before such date shall be treated as issued before January 1, 1984. A similar rule shall apply in the case of a series of exchanges.

(8) Subsection to apply to policies provided under employee benefit plans.—This subsection shall not apply to any policyholder dividend paid or accrued with respect to a group policy issued in connection with a plan to provide welfare benefits to employees (within the meaning of section 419(e)(2)).

* * * *

26 U.S.C. § 809 provides:

Redution in certain deductions of mutual life insurance companies

(a) General rule.—

(1) Policyholder dividends.—In the case of any mutual life insurance company, the amount of the deduction allowed under section 808 shall be reduced

(but not below zero) by the differential earnings amount.

(2) Reduction in reserve deduction in certain cases.—In the case of any mutual life insurance company, if the differential earnings amount exceeds the amount allowable as a deduction under section 808 for the taxable year (determined without regard to this section), such excess shall be taken into account under subsections (a) and (b) of section 807.

(3) Differential earnings amount.—For purposes of this section, the term "differential earnings amount" means, with respect to any taxable year, an amount equal to the product of—

(A) the life insurance company's average equity base for the taxable year, multiplied by

(B) the differential earnings rate for such taxable year.

(b) Average equity base.—For purposes of this section—

(1) In general.—The term "average equity base" means, with respect to any taxable year, the average of—

(A) the equity base determined as of the close of the taxable year, and

(B) the equity base determined as of the close of the preceding taxable year.

(2) Equity base.—The term "equity base" means an amount determined in the manner prescribed by regulations equal to—

(A) the surplus and capital,

(B) adjusted as provided in paragraphs (3), (4), (5), and (6) of this subsection.

No item shall be taken into account more than once in determining equity base.

(3) Increase for nonadmitted financial assets.—

(A) In general.—The amount of the surplus and capital shall be increased by the amount of the nonadmitted financial assets.

(B) Nonadmitted financial assets.—For purposes of subparagraph (A), the term "nonadmitted financial asset" means any nonadmitted asset of the company which is—

(i) a bond,

(ii) stock,

(iii) real estate,

(iv) a mortgage loan on real estate, or

(v) any other invested asset.

(4) Increase where statutory reserves exceed tax reserves.—

(A) In general.—If—

(i) the aggregate amount of statutory reserves, exceeds

(ii) the aggregate amount of tax reserves,

the amount of the surplus and capital shall be increased by the amount of such excess.

(B) Definitions.—For purposes of this paragraph—

(i) Statutory reserves.—The term "statutory reserves" means the aggregate amount set forth in the annual statement with respect to items described in section

807(c). Such term shall not include any reserve attributable to a deferred and uncollected premium if the establishment of such reserve is not permitted under section 811(c).

(ii) Tax reserves.—The term "tax reserves" means the aggregate of the items described in section 807(c) as determined for purposes of section 807.

(5) Increase by amount of certain other reserves.—The amount of the surplus and capital shall be increased by the sum of—

(A) the amount of any mandatory securities valuation reserve,

(B) the amount of any deficiency reserve, and

(C) the amount of any voluntary reserve or similar liability not described in subparagraph (A) or (B).

(6) Adjustment for next year's policyholder dividends.—The amount of the surplus and capital shall be increased by 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year.

(c) Differential earnings rate.—

(1) In general.—For purposes of this section, the differential earnings rate for any taxable year is the excess of—

(A) the imputed earnings rate for the taxable year, over

(B) the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

(2) Transitional rule.—The differential earnings rate—

(A) for any taxable year beginning in 1984, or

(B) for purposes of computing the amount of underpayment under section 6655 (including the application of section 6655(d)(3)) for any taxable year beginning in 1985,

shall be equal to 7.8 percent.

(3) Coordination with estimated tax payments.—For purposes of applying section 6655 with respect to any installment of estimated tax, the amount of tax shall be determined by using the lesser of—

(A) the differential earnings rate of the second tax year preceding the taxable year for which the installment is made, or

(B) the differential earnings rate for the taxable year for which the installment is made.

(d) Imputed earnings rate.—

(1) In general.—For purposes of this section, the imputed earnings rate for any taxable year is—

(A) 16.5 percent in the case of taxable years beginning in 1984, and

(B) in the case of taxable years beginning after 1984, an amount which bears the same ratio to 16.5 percent as the current stock earnings rate for the taxable year bears to the base period stock earnings rate.

(2) Current stock earnings rate.—For purposes of this subsection, the term "current stock earnings rate" means, with respect to any taxable year, the average of the stock earnings rates determined under paragraph (4) for the 3 calendar years preceding the calendar year in which the taxable year begins.

(3) Base period stock earnings rate.—For purposes of this subsection, the base period stock earnings rate is the average of the stock earnings rates determined under paragraph (4) for calendar years 1981, 1982, and 1983.

(4) Stock earnings rate.—

(A) In general.—For purposes of this subsection, the stock earnings rate for any calendar year is the numerical average of the earnings rates of the 50 largest stock companies.

(B) Earnings rate.—For purposes of subparagraph (A), the earnings rate of any stock company is the percentage (determined by the Secretary) which—

(i) the statement gain or loss from operations for the calendar year of such company, is of

(ii) such company's average equity base for such year.

(C) 50 largest stock companies.—For purposes of this paragraph, the term "50 largest stock companies" means a group (as determined by the Secretary) of stock life insurance companies which consists of the 50 largest domestic stock life insurance companies which are subject to tax under this part. The Secretary—

(i) shall, for purposes of determining the base period stock earnings rate, exclude from the group determined under the preceding sentence any company which had a negative equity base at any time during 1981, 1982, or 1983.

(ii) shall exclude from such group for any calendar year any company which has a negative equity base, and

(iii) may by regulations exclude any other company which otherwise would have been included in such group if the inclusion of the excluded company or companies would, by reason of the small equity base of such company, seriously distort the stock earnings rate.

The aggregate number of companies excluded by the Secretary under clause (iii) shall not exceed the excess of 2 over the number of companies excluded under clause (ii).

(D) Treatment of affiliated groups.—For purposes of this paragraph, all stock life insurance companies which are members of the same affiliated group shall be treated as one stock life insurance company.

(e) Average mutual earnings rate.—For purposes of this section, the average mutual earnings rate for any calendar year is the percentage (determined by the Secretary) which—

(1) the aggregate statement gain or loss from operations for such year of domestic mutual life insurance companies, is of

(2) their aggregate average equity bases for such year.

(f) Recomputation in subsequent year.—

(1) Inclusion in income where recomputed amount greater.—In the case of any mutual life insurance company, if—

(A) the recomputed differential earnings amount for any taxable year, exceeds

(B) the differential earnings amount determined under this section for such taxable year,

such excess shall be included in life insurance gross income for the succeeding taxable year.

(2) Deduction where recomputed amount smaller.—In the case of any mutual life insurance company, if—

(A) the differential earnings amount determined under this section for any taxable year, exceeds

(B) the recomputed differential earnings amount for such taxable year,

such excess shall be allowed as a life insurance deduction for the succeeding taxable year.

(3) Recomputed differential earnings amount.—For purposes of this subsection, the term "recomputed differential earnings amount" means, with respect to any taxable year, the amount which would be the differential earnings amount for such taxable year if the average mutual earnings rate taken into account under subsection (c)(1)(B) were the average mutual earnings rate for the calendar year in which the taxable year begins.

(4) Special rule where company ceases to be mutual life insurance company.—Except as provided in section 381(c)(22), if—

(A) a life insurance company is a mutual life insurance company for any taxable year, but

(B) such life insurance company is not a mutual life insurance company for the succeeding taxable year,

any adjustment under paragraph (1) or (2) by reason of the recomputed differential earnings amount for the first of such taxable years shall be taken into account for the first of such taxable years.

(5) Subsection not to apply for purposes of estimated tax.—Section 6655 shall be applied to any

taxable year without regard to any adjustments under this subsection for such year.

(g) Definitions and special rules.—For purposes of this section—

(1) Statement gain or loss from operations.—The term "statement gain or loss from operations" means the net gain or loss from operations required to be set forth in the annual statement, determined without regard to Federal income taxes, and—

(A) determined by substituting for the amount shown for policyholder dividends the amount of deduction for policyholder dividends determined under section 808 (without regard to section 808(c)(2)),

(B) determined on the basis of the tax reserves rather than statutory reserves, and

(C) properly adjusted for realized capital gains and losses and other relevant items.

(2) Other terms.—Except as otherwise provided in this section, the terms used in this section shall have the same respective meanings as when used in the annual statement.

(3) Determinations based on amount set forth in annual statement.—Except as otherwise provided in this section or in regulations, all determinations under this section shall be made on the basis of the amounts required to be set forth on the annual statement.

(4) Annual statement.—The term "annual statement" means the annual statement for life insurance companies approved by the National Association of Insurance Commissioners.

(5) Reduction in equity base for portion of equity allocable to life insurance business in noncontiguous

western hemisphere countries.—The equity base of any mutual life insurance company shall be reduced by an amount equal to the portion of the equity base attributable to the life insurance business multiplied by a fraction—

(A) the numerator of which is the portion of the tax reserves which is allocable to life insurance contracts issued on the life of residents of countries in the Western Hemisphere which are not contiguous to the United States, and

(B) the denominator of whih is the amount of the tax reserves allocable to life insurance contracts.

The preceding sentence shall not apply unless the fraction determined under the preceding sentence exceeds 1/20.

(6) Special rule for certain contracts issued before January 1, 1985.—In determining the amount of tax reserves of a subsidiary of a mutual insurance company for purposes of subsection (b)(4), section 811 (d) shall not apply with respect to any life insurance contract issued before January 1, 1985, under a plan of life insurance in existence on July 1, 1983.

(h) Treatment of stock companies owned by mutual life insurance companies.—

(1) Treatment as mutual life insurance companies for purposes of determining stock earnings rates and mutual earnings rates.—Solely for purposes of subsections (d) and (e), a stock life insurance company shall be treated as a mutual life insurance company if stock possessing—

(A) at least 80 percent of the total combined voting power of all classes of stock of such stock life insurance company entitled to vote, or

(B) at least 80 percent of the total value of shares of all classes of stock of such stock life insurance company,

is owned at any time during the calendar year directly (or through the application of section 318) by one or more mutual life insurance companies.

(2) Treatment of affiliated group which includes mutual parent and stock subsidiary.—In the case of an affiliated group of corporations which includes a common parent which is a mutual life insurance company and one or more stock life insurance companies, for purposes of determining the average equity base of such common parent (and the statement gain or loss from operations)—

(A) stock in such stock life insurance companies held by such common parent (and dividends on such stock) shall not be taken into account, and

(B) such common parent and such stock life insurance companies shall be treated as though they were one mutual life insurance company.

(3) Adjustment where stock company not member of affiliated group.—In the case of any stock life insurance company which is described in paragraph (1) but is not a member of an affiliated group described in paragraph (2), under regulations, proper adjustments shall be made in the average equity bases (and statement gains or losses from operations) of mutual life insurance companies owning stock in such company as may be necessary or appropriate to carry out the purposes of this section.

(i) Transitional rule for certain high surplus mutual life insurance companies.—

(1) In general.—For purposes of subsection (a)(3), the average equity base of a high surplus mutual life insurance company for any taxable year shall not

include the applicable percentage of the excess equity base of such company for such taxable year.

(2) Definitions.—For purposes of this subsection—

(A) Excess equity base.—The term "excess equity base" means the excess of—

(i) the average equity base of the company for the taxable year, over

(ii) the amount which would be its average equity base if its equity percentage equaled the following percentage:

For taxable years beginning in:	The percentage is:
1984	14.5
1985 or 1986	14
1987 or 1988	13.5

In no case shall the excess equity base for any taxable year be greater than the excess equity base for the company's first taxable year beginning in 1984.

(B) Applicable percentage.—The term "applicable percentage" means the percentage determined in accordance with the following table:

For taxable years beginning in:	The applicable percentage is:
1984	100
1985	80
1986	60
1987	40
1988	20
1989 or thereafter	0.

(C) High surplus mutual life insurance company.—The term "high surplus mutual life in surance company" means any mutual life insur-

ance company if, for the taxable year beginning in 1984, its equity percentage exceeded 14.5 percent.

(D) Equity percentage.—The term "equity percentage" means, with respect to any mutual life insurance company, the percentage which—

(i) the average equity base of such company (determined under this section without regard to this subsection) for a taxable year bears to

(ii) the average of—

(I) the assets of such company as of the close of the preceding taxable year, and

(II) the assets of such company as of the close of the taxable year.

For purposes of the preceding sentence, the assets of a company shall include all assets taken into account under this section in determining its equity base (after applying the principles of subsection (h)).

* * * *

26 U.S.C. § 1032 provides:

Exchange of stock for property

(a) Nonrecognition of gain or loss.—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).

(b) Basis.—

For basis of property acquired by a corporation in certain exchanges for its stock, see section 362.

* * * *

Treasury Regulation § 1.811-2(a) (1961) provides:

(a) Dividends to policyholders defined. Section 811 (a) defines the term "dividends to policyholders" for purposes of Part I, Subchapter L, Chapter 1 of the Code, to mean dividends and similar distributions to policyholders in their capacity as such. The term includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management. In general, any payment not fixed in the contract which is made with respect to a participating contract (that is, a contract which during the taxable year contains a right to participate in the divisible surplus of the company) shall be treated as a dividend to policyholders. Similarly, any amount refunded or allowed as a rate credit with respect to either a participating or a nonparticipating contract shall be treated as a dividend to policyholders if such amount depends on the experience of the company. However, the term does not include interest paid (as defined in section 805(e) and paragraph (b) of § 1.805-8) or return premiums (as defined in section 809(c) and paragraph (a)(1)(ii) of § 1.809-4). Thus, so-called excess-interest dividends and amounts returned by one life insurance company to another in respect of reinsurance ceded shall not be treated as dividends to policyholders even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of the management.

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